SUBCOMMITTEE HEARING ON IMPROVING THE SBA'S ACCESS TO CAPITAL PROGRAMS FOR OUR NATION'S SMALL BUSINESSES

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SUBCOMMITTEE HEARING ON IMPROVING THE SBA'S ACCESS TO CAPITAL PROGRAMS FOR OUR NATION'S SMALL BUSINESSES

Wednesday, March 5, 2008

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Subcommittee met, pursuant to call, at 2:00 p.m., in Room 2360 Rayburn House Office Building, Hon. Melissa Bean [chairwoman of the Subcommittee] presiding.

Present: Representatives Bean and Buchanan.

Also Present: Representative Velázquez.

OPENING STATEMENT OF CHAIRWOMAN BEAN

Chairwoman BEAN. Calling this hearing to order. Today the Committee will examine the SBA's lending and investment programs and what steps the agency is taking to strengthen these initiatives.

This hearing is timely given concerns about the economy, particularly the tightening of credit availability following the subprime mortgage fallout. The access to capital is critical to small business, investment, growth, and competitiveness.

The current down turn, rising loan foreclosures, and a falling housing market have caused financial institutions to tighten their credit standards. As a recent Federal Reserve survey confirms, more than 30 percent of lenders are raising their lending criteria for small firms.

For entrepreneurs, the rising cost of capital can cause many to forego important purchases or expansion. This dampening effect has the potential to reduce entrepreneurial activity in the short term and further hinder economic growth over the long term.

In this environment, the SBA's lending and investment programs played their most vital role as there was an opportunity to provide capital to businesses who can no longer access affordable private alternatives.

Small businesses are the nation's largest employer and create roughly 80 percent of domestic job growth. Today's hearing seeks to determine what steps the SBA is taking to meet the needs of our nation's small businesses, making access to their loan programs easier.

Recently, instead of providing crucial financing for small businesses, challenges facing the agency have resulted in reduced lender participation, lower loan volume to small businesses, and rising costs.

As we will hear today, many of these developments are in the agency's flagship 7(a) loan program, the dollar amount of 7(a) loans are decreasing, and the number of financial institutions participating in the program have been declining. A new 7(a) oversight fee has been added. And even more fees are proposed for next year. These new costs come at a time when small businesses can least afford them.

Last year the House took action to address these concerns by passing H.R. 1332, a bill that I sponsor. At the same time, the agency's seed capital initiative, the SBIC's, participating securities program remains closed with little help of seeing new life. This program is critical to small business growth as sources of equity investment dry up quickly in economic down turns.

Small high-growth entrepreneurs are left with fewer options for financing. Again, there are solutions on the table, including H.R. 3567, which creates a new start-up financing program that passed the House by a strong bipartisan vote.

Further restricting access to capital, the administration proposed this year to increase the interest rates borrowers pay for microloans. This will have the effect of raising the cost of loans for low-income borrowers at a time when other options are not available.

H.R. 3020, which was sponsored by Ranking Member Chabot, takes steps to modernize the program without raising the costs for low-income borrowers. This bill has also passed the House this session.

While the Committee is working to advance these proposals in the Senate, several new laws have recently been enacted to provide low-cost small business loans for veterans and energy-efficient technologies. These types of initiatives show great promise to get capital in the hands of entrepreneurs. And we look forward to the SBA's near-term implementation of them both.

It is clear that SBA's lending and investment programs are an important tool for small businesses, particularly in a faltering economy. As businesses face challenges securing affordable financing, the commitment to modernize and strengthen these initiatives will provide necessary alternatives. Our hearing will call attention to the challenges facing these programs so that Congress can act quickly to provide the resources and reforms needed for the growth and expansion of our community businesses.

I want to thank all of our witnesses who are here today in advance for your testimony and subject matter expertise and now recognize our ranking member for his opening statement.

OPENING STATEMENT OF MR. BUCHANAN

Mr. BUCHANAN. I want to thank the Chair for yielding and for calling this hearing today on a matter important to millions of Americans. I would like to also extend my thanks to our witnesses, who have taken time out of their busy schedules to provide this Subcommittee with testimony today.

Today too many small business entrepreneurs find themselves struggling in this volatile economy. They're entangled in government red tape, victimized by excessive frivolous litigation, or burdened by high cost of health care. But all of this is made worse when small businesses cannot access the capital it needs to start or expand an enterprise.

The SBA 7(a) and the 504 lending programs are vital for the success of our nation's small businesses. It is evident that the number of lenders on the SBA financing program has decreased. And, of course, some of that decrease is attributable to the continuing consolidation of the banking industry.

While the SBA is trying to increase participation in this program, it also has taken steps that make it tough by raising fees to lenders. This is one of the areas that I hope we can discuss a little bit more today.

The good news is we have made important strides in this Committee over the past year. Chairwoman Bean sponsored and I support bipartisan legislation aimed at reducing lending fees and increasing small business access to capital.

H.R. 1332 improves and strengthens the SBA program, successful program 7(a) and the CDC loan programs. This pivotal legislation enables the SBA financing programs to operate without subsidy. And that is important. Should tax dollars be appropriated, the bill would require these additional funds to be used to reduce borrowing fees.

And, finally, regarding the SBA investment program, obviously a small business in short supply of needed capital is faced with the choice of either accumulating more debt in forms of loan or reducing its control of the company by selling stock to investors, but the SBA program in attracting investment are tough cases that are unclear and helpful. The business owners can be hit with enormous tax penalties if it sells its equity where small business investment can itself tax the public treasury if unforeseen loopholes are allowed to escape scrutiny.

The SBA was created to help small business compete in good times and survive in tough times. The essential purpose of these hearings is to determine whether existing programs are as constituted fair to both the borrower and the lender and determine whether the cost of possible reforms do not unduly penalize the American taxpayer.

I look forward to working with Chairwoman Bean to ensure that the SBA financing program operates as efficiently and as effectively as possible. Thank you, and I yield back.

Chairwoman BEAN. Thank you.

We will now move to testimony from our witnesses. Witnesses will have five minutes to deliver their prepared statements. The timer begins when the green light is illuminated. When one minute of time remains, the light will turn yellow. The red light will come on when time is up.

Our first witness is the honorable Eric Zarnikow. In November of last year, Mr. Zarnikow was appointed as the Associate Administrator for SBA's Office of Capital Access. Prior to his appointment, he worked for Service Master back in Illinois, where we are both from, as the Senior Vice President, Chief Risk Officer, and Treasurer.

Thank you. And you may now proceed.

STATEMENT OF THE HONORABLE ERIC ZARNIKOW, ASSOCIATE ADMINISTRATOR FOR CAPITAL ACCESS, ADMINISTRATOR, U.S. SMALL BUSINESS ADMINISTRATION

Mr. ZARNIKOW. Chairwoman Bean, Ranking Member Buchanan, thank you for inviting me here today to testify about the U.S. Small Business Administration's fiscal year 2009 budget for capital access programs. As you know, I am the Associate Administrator for Capital Access.

The budget request for 2009 reflects the President's commitment to America's small businesses and supports Administrator Preston's reform agenda. Since 2001, the SBA programs have continued to grow while we have worked to streamline processes, make technological improvements, and develop tools that increase our effectiveness.

The SBA continues to reach more small businesses through our loan programs and doing so at no subsidy cost to the taxpayer. In fiscal year 2007, the SBA provided funding to 89,400 small businesses in the 7(a) and 504 loan programs.

We look forward to continuing to work with the Committee to continue to improve access to SBA's services by the small business community. Our goal is to implement improvements that are employee-enabled, efficient, transparent, and effective.

We are also focused on lender outreach and retention. We will continue to ensure capital access products and services are accessible to entrepreneurs in the nation's most under-served markets: those with higher rates of unemployment and poverty and lower rates of economIC progress.

The President's fiscal year 2009 proposal will support a total of $28 billion in lending authority for small business financing. The proposal requests authorizations of 17 and a half billion for the 7(a) program, 7 and a half billion for the 504 program, 3 billion for the SBIC debenture program, and 25 million for the microloan program.

In 2007, we served more small businesses than ever before. In our two major loan programs, the numbers of gross approvals increased by 123 percent from fiscal year 2001 to over 110,000 loans in fiscal year 2007.

A recent Urban Institute study found that loans under the 7(a) and 504 programs were more likely to go to minority-owned, women-owned, and start-up businesses, as compared to conventional small business loans.

Zero subsidy policy in the 7(a), 504, and SBIC programs has allowed the agency to provide record levels of lending without the need for taxpayer-provided credit subsidy appropriations while maintaining fee rates consistent with historical levels. This policy has provided certainty and stability for the 7(a) loan program, which both borrowers and lenders agree is critical for this widely-used program while also reducing taxpayers' costs.

In fiscal year 2007, more than 2,000 small businesses benefited from over 700 million in SBIC investments. The SBA is working to increase our outreach efforts by participating in a number of forums to heighten the visibility of SBIC programs within all market segments.

Effectively managing agency resources devoted to SBA lending activity is another key priority, centralized 7(a) loan guaranty purchase and liquidation functions as well as 504 loan processing. Centralization allows for more consistent application of SBA's processes and procedures.

Despite record growth in 2007, there is a decline in SBA lending year-to-date approvals for fiscal year 2008, constantly monitoring loan levels and working with lenders and small businesses to ensure that we continue to meet the needs of the small business community.

And we are conducting a number of lender outreach and retention efforts. In fact, this morning we had an outreach event at the White House with lenders and senior administration officials. And we appreciate your agreeing to change or changing the time of this hearing.

Additionally, we have provided lenders with new loan products to help them reach specific sectors of the small business community and will continue to work with lenders to find better ways to serve small businesses.

We want to continue to strengthen and support lender oversight and risk management functions of the agency. The SBA has increased its on-site review of lenders from 55 in 2006 to 80 in 2007. And we currently plan to do over 200 on-site reviews in 2008. We have also made improvements to our lender portal that is a key oversight tool used to monitor the lender portal or portfolio.

Earlier this year we launched the pilot of the rural lender advantage initiative as a way to work with community lenders that are key to providing lending to economically distressed rural areas. This initiative simplifies application procedures and expands assistance to banks that do not regularly work with the SBA.

Another product that we are very proud of is the Patriot Express loan initiative. This product of our 7(a) program provides capital to veterans, members of the National Guard and Reserve and their spouses. This was launched in June of last year. We have seen over $100 million of loans provided to veterans for this program.

To expand capital to certain sectors of our economy in underserved communities, the agency has also proposed a change to zero subsidy for the microloan program. By changing the rate at which intermediaries borrow from the SBA from about 3.8 percent to about 5.92 percent, intermediaries will continue to receive better-than-market rates of interest, and the SBA will be able to offer more loans to eligible intermediaries.

The SBA also proposes shifting microloan technical assistance to our extensive network of existing resource partners. That has the potential of tripling the number of outlets available for micro enterprise lenders. In addition, we are in the process of rolling out online technical assistance for availability.

Over 300 million of U.S. exports, about 30 percent of U.S. exports, are originated by small businesses, generating thousands of jobs and billions of dollars of income.

International trade exposes American small businesses to new ways of doing business and from a technology and a management perspective making them more competitive. We have widened our staff with the Commerce Department to provide services to small businesses seeking exports.

Chairwoman BEAN. If you could wrap up—

Mr. ZARNIKOW. Sure.

Chairwoman BEAN. —because you are a little over time and votes have been called?

Mr. ZARNIKOW. In conclusion, 2007 was a year of significant accomplishments for the capital access programs. And with this budget request, we look forward to continuing to build on those successes. We would be glad to answer any questions that you have today.

[The prepared statement of Mr. Zarnikow may be found in the Appendix on page 30.]

Chairwoman BEAN. Thank you for your testimony.

We are being called for a vote. So the Committee stands at recess subject to the call of the Chair. And then we will resume. Thank you.

[Brief recess.]

Chairwoman BEAN. We will call this hearing back to order and move to testimony from our next witness, which is Mr. Christopher Crawford, who is President and CEO of the National Association of Development Companies. NADCO was formed in 1981 and provides legislative and regulatory support for the SBA's 504 program on behalf of member-certified development companies, or CDCs.

Thank you for being here.

STATEMENT OF MR. CHRISTOPHER CRAWFORD, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL ASSOCIATION OF DEVELOPMENT COMPANIES

Mr. CRAWFORD. Thank you, Madam Chair.

As you indicated, my name is Chris Crawford. I am the President of the National Association of Development Companies. NADCO represents some 260 certified development companies and another 200 affiliates. Together they provide more than 98 percent of all 504 lending.

I want to thank the Subcommittee for inviting me to comment on access to capital for small businesses. Given the credit crisis our country is now engulfed in, I can think of no better time than now to consider what our industry feels we need to, number one, get small businesses growing jobs again; and, number two, get SBA on the right track to help, rather than hinder, lenders.

First I want to thank the Committee for its support for the last 20 years. With your help, we have been able to grow the program from under $200 million per year in 504 loans to this year something probably north of $6.5 billion with another $8 billion in generally bank-originated first mortgages to go in our projects.

First I would like to talk about the authorization level. 504, as you know, is flat year to date, which, given the slide in loan demand for this country, is really pretty good. I expect loan volume to be a bit under 7 billion by the end of this fiscal year.

SBA has asked for 7.5 billion for fiscal year 2009, which leaves 504 with too little expansion room if borrowers begin to utilize 504 more due to the existing and the continuing credit crunch. I ask this Committee to provide an authorization level of at least 8.5 billion for fiscal year 2009 or I believe we risk running out of money during that year.

Five-o-four is a zero subsidy program. So there is absolutely no cost for adding loan authority to the President's budget. And I urge you to do so in fiscal year 2009.

I would like to talk about fees. SBA decreased the annual borrower fee to zero for fiscal year 2009 but still placed 504 in what is called a negative subsidy situation. That is, the program's other fees will be putting more money into the U.S. Treasury than 504 is actually projected to cost during '09. Even though it is only a small amount according to SBA, it is about $1.4 billion that small businesses could use to add jobs or buy equipment.

Frankly, NADCO is appalled that SBA would needlessly take fees from small businesses during a recession. And we ask Congress to pass legislation to adjust our fees to exactly zero subsidy, not a negative subsidy.

I would like to address CDC lender oversight. SBA issued a proposed regulation on lender oversight. And NADCO was one of many organizations to express concerns over this proposal. No one wants accurate, consistent oversight of 504 more than the CDC industry.

We believe that to maintain low fees, SBA must ensure that CDCs meet the lending, servicing, and liquidation standards required of a zero subsidy program. However, this oversight process has one potentially fatal flaw: its reliance on an unproven database that attempts to identify potential defaulting borrowers years before they might possibly default. That is kind of like predicting the weather in Washington.

SBA is currently seeking to renew this contract for this database. We urge this Congress to step in and demand an unbiased outside verification of this forecasting system by firms with both credit underwriting and financial modeling expertise. Two lending industries should not be held hostage and regulated through such an unproven process.

I would like to touch on liquidation. Our default rate right now is about four percent, and our loss rate is barely two percent. However, as in previous recessions, defaults appear to be rising a bit. We obviously want to avoid what you might call a subprime scenario for 504. And that means there must be skilled personnel involved in liquidations and workouts.

Unfortunately, SBA has, I believe, not hired a sufficient number of staff to work liquidations internally after having laid off virtually all of their liquidation staff approximately four years ago.

Today SBA is not complying with the intent of the 106th Congress or even its own regulations by handling liquidations and reimbursing CDCs for their liquidation efforts. It appears that SBA has not budgeted for these funds for either this year or next year to reimburse CDCs for this cost. The result is going to be there are going to be very few people, industry people or SBA people, to perform liquidations on defaulted 504s. I ask the Congress to pass legislation to require the SBA to allocate funds from increased recoveries to enable CDCs to handle liquidations.

A recent study by the California State University has concluded that 504 returns $94 for every $1 of SBA administrative costs for 504. This is an incredible benefit ratio, but it works only if the program has accurate and consistent oversight and can recover its loan defaults that occur in the portfolio.

NADCO asks the Committee to support these program needs and to quickly pass legislation to keep 504 on the right track. Thank you very much.

[The prepared statement of Mr. Crawford may be found in the Appendix on page 34.]

Chairwoman BEAN. Thank you for your testimony.

Our next witness is Mr. Lee Mercer, who is President of the National Association of Small Business Investment companies. NASBIC has represented the SBIC industry since Congress established the program in 1958.

STATEMENT OF MR. LEE MERCER, PRESIDENT, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

Mr. MERCER. Thank you, Madam Chair, Mr. Buchanan. Thank you for the opportunity to appear today to give NASBIC's recommendations for improving the SBA's access to capital programs. I have provided some background on the SBIC program in my written testimony but will jump immediately to our recommendations.

First, improve the debenture SBIC program as it runs at a zero subsidy rate. The House Small Business Committee, the full Committee, has lead the way by securing passage by the full House of H.R. 3567, the Small Business Investment Expansion Act of 2007.

The bill contains two provisions, sections 101 and 105, that are very important to both greater growth in the program and greater potential for each individual SBIC to help every small business in which it invests. Both provisions would make the program more attractive to private investors and to private management teams, thus leading to greater growth in the program. Neither provision has been opposed by the administration.

Unfortunately, the counterpart Senate bill, S. 1662, is bogged down because of a hold place on the bill by a single Senator opposed to the SBIC program as a whole. We hope this can be remedied prior to the adjournment of this Congress.

Second recommendation, revive the participating security program. Warren Buffett said this week, "By any common sense definition, we are in a recession." That fact will make the availability of equity capital even more important to America's small businesses. Equity capital is the foundation upon which every company is built.

As outlined in my testimony, the participating security program has been a great success in providing that equity capital, having provided 14 billion in equity investments since 1994.

Yes, the government will lose money on the program, a result of losses from the 2000 recession, when all investors lost money and SBICs no more than most. But the losses will be substantially less than projected by OMB.

OMB says that the recoveries from participating security SBICs in liquidation will only be 35 percent. In fact, recoveries for fiscal year 2006 and fiscal year 2007 ran at 64 percent, 83 percent more than forecast by OMB. Over $600 million was recovered in just 2 years.

What is debt? The Credit Reform Act of 1990 does not define the word "debt." Absent a definition within the statute, words are subject to the Supreme Court-promulgated plain meaning rule of statutory construction. Words must be given their ordinary meaning.

The word "debt" is defined in many ordinary contexts: a duty or obligation to pay money, a note or bond which represents an amount owed, a liability on a claim. Based on these definitions, both Generally Accepted Accounting Principles, GAAP, and SBA's own SBIC regulations require that participating securities be listed as debts on the financial statements of all participating security SBICs. How can the government have it both ways?

Section 303 of the Small Business Investment Act makes it clear that a participating security is a debt for subsidy scoring. Section 303(g)(1) states, "Participating securities shall be repaid not later than 15 years after their date of issuance." The section creates an unambiguous obligation to pay money on the claim created by the security.

Section 303(g)(5) states, "The only debt other than leverage a company issuing participating securities may have outstanding shall be temporary debt." The phrase "only debt other than leverage" is unambiguous. Congress considered both participating securities and debentures to be debts.

Finally, 303(j) states, "All fees, interest, and profits received by the administration under this section shall be included in the calculations made by the director of OMB to offset the cost as defined by the Federal Credit Reform Act of 1990 to the administration of purchasing and guaranteeing debentures and participating securities."

Section 303(j) makes crystal clear the congressional intent that the securities issued under the program qualify for subsidy scoring. Only if qualified could receipts be used to offset costs. Since the Federal Credit Reform Act was passed eight years prior to the legislation creating the participating security program, it must be assumed, it has to be assumed, that Congress knew the law. If it did not intend participating securities to be debts for the purposes of the Federal Credit Reform Act, it would not have made the receipts deductible from costs in under 303(j).

With OMB so wrong and so intransigent, a simple legislative change would revive the participating securities program. I have provided the language for that change in my testimony. It is very simple. It just says in the enabling act, "Participating securities guaranteed under this subsection shall be considered debt securities for all purposes related to the Federal Credit Reform Act."

Amending the Small Business Investment Act as suggested would correct the erroneous unjustifiable holding by OMB and CBO and again make the participating security program a very effective partner in providing scarce equity capital to America's small businesses.

Thank you for your consideration.

[The prepared statement of Mr. Mercer may be found in the Appendix on page 39.]

Chairwoman BEAN. Thank you for your testimony.

Next is Mr. Daniel Betancourt from the Community First Fund, established in 1992. It is a nonprofit community development financial institution serving a 13-county region in central Pennsylvania. Mr. Betancourt is also testifying today on behalf of the Association for Enterprise Opportunity. AEO's nearly 500 members are serving the needs of micro entrepreneurs.

Thank you for being here.

STATEMENT OF MR. DANIEL BETANCOURT, PRESIDENT AND CHIEF EXECUTIVE OFFICER, COMMUNITY FIRST FUND, ON BEHALF OF THE ASSOCIATION FOR ENTERPRISE OPPORTUNITY

Mr. BETANCOURT. Thank you, Chairwoman. Thank you, Ranking Member Buchanan.

As you said, I chair the Association for Enterprise Opportunity. We have over 600 members. We are a leadership organization for micro enterprise. And many of our members have the SBA microloan program.

I am also a practitioner. Our organization is a micro lending program in Pennsylvania.

Thank you for the opportunity. I wanted to talk about the differences between the microloan program and the 7(a) and other SBA programs. Clearly the private sector, the banking is not serving the entrepreneurs as it relates to lending. The SBA microloan program is a very unique program. The 7(a) program, as I said, and the CommunityExpress do not serve this group.

The unique thing about the program, as you know, it combines the business accounts and the technical assistance along with the lending. The thing that is interesting about this program is that the way that it works with organizations like ours, it provides our time to work with the entrepreneur to help them borrow the money from our organization, organizations like ours, as well as provide training at a low-cost capital. In other words, the money that we borrow and the money that is granted to us allows us to do both of those things, training and to lend and re-lend.

What we find is when banks try to lend to entrepreneurs that we lend to they get into trouble pretty quickly because you don't spend the amount of time or banks don't spend the time with these entrepreneurs. So it's critical to provide that time to them.

Many of these businesses would not even be able to get financing. They wouldn't be able to get off the ground. The interesting thing is that the demographics of these entrepreneurs, 90 percent of our borrowers are low-to-moderate-income borrowers.

We are probably very unique, Community First Fund, in that we also have the 7(a) program, probably one of the few organizations in the country that offers the SBA microloan as well as a 7(a). And what we find is that our 7(a) borrowers are not low-to-moderate-income individuals. They're higher-wealth individuals, many of which have high credit scores, they have collateral, and they really don't need that type of program.

As I said, this program, the SBA microloan, does provide that low capital to us. We are able to also—as you know, the requirement of the programs that we have to provide, a 15 percent match, for loan loss reserves, I think and we think, the AEO thinks it is a good use of federal dollars. It has the lowest default rate of any SBA program, one percent default rate. Our organizations when we borrow, we pay back, even if our borrowers don't pay us because of that reserve fund that we have.

The entrepreneurs are well-prepared to borrow from us. We spend that time with them with the technical assistance. And I think that is one of the key strengths of this program.

And I really want to talk to you about the President's proposal here. He is recommending through the budget to eliminate the technical assistance portion as well as raising the rates the second year in a row. We think that this is unworkable.

Organizations like ours, some of our borrowings are two to four percent. And we have to add a loan loss reserve rate to that. It would be a pretty high rate. You would have to raise the cap rates for us to be able to lend at the same rates. So that is going to be a burden to an organization like ours. We think it is going to be a burden to entrepreneurs.

I want to say this for the record. We would have to pass those costs along to the entrepreneurs. And we think that this is going to be a real hardship on the entrepreneurs. We think this increased capital is going to provide less jobs. less people will use the program.

The President, as I said, is also recommending to eliminate the technical assistance. Quite frankly, we don't know how we can just lend to entrepreneurs without providing that type of assistance. We don't think that it would work.

I think there is a myth out there that if you find another technical assistance provider to provide technical assistance to our clients, that it will get paid back.

This is a very important point. We have had in our own community,—and I won't mention names—we have had other technical assistance providers try to get us paid back. It just doesn't work. They don't have an incentive to get us paid back. Our money is out in the street. We are putting the risks out there. So we are going to do everything we can to get our money back.

So I think that is a real myth to think that another organization can try to get our money back. I don't think a bank would ever. Well, they can outsource things, but, quite frankly, their incentive is to get paid back.

The 7(a) program I think is a very good program. As I said, we have that. It's a different demographic. The microloan program in our particular case serves—at least our borrowers are 50 percent rural, 50 percent urban. Half of our clients are folks of color. Half are women. It is a very unique program. It is serving the population that you intended when you passed this.

So I just wanted to say that we appreciate your support in the past. We are looking forward to working with you in the future. And thank you for this opportunity to talk with you. Thank you.

[The prepared statement of Mr. Betancourt may be found in the Appendix on page 45.]

Chairwoman BEAN. Thank you for your testimony.

Mr. Anthony Wilkinson provides our last testimony before we go to questions and answers. Mr. Wilkinson is the President and CEO of the National Association of Government Guaranteed Lenders. NAGGL advocates for the interest of the small business lending community that utilizes SBA and other government-guaranteed loan programs.

STATEMENT OF MR. ANTHONY WILKINSON, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL ASSOCIATION OF GOVERNMENT GUARANTEED LENDERS

Mr. WILKINSON. Thank you, Chairwoman Bean, Ranking Member Buchanan. I appreciate the opportunity to testify today.

NAGGL is a trade association. We represent approximately 700 banks, credit unions, non-depository lenders and service providers who participate in SBA's loan programs.

Our membership generates approximately 80 percent of all of the 7(a) loan volume annually and a majority of the 504 first mortgage loans. But these are difficult times for participants of SBA loan programs. Lenders and small business owners are facing uncertain economic conditions, decreasing profitability, and rising expenses. Small business owners need access to capital to succeed. And the SBA offers the primary vehicle for delivering that much needed long-term capital.

However, SBA loan volume is declining. The pool of active, participating lenders is shrinking. And lender fees and costs continue to rise.

Unfortunately, the budget cuts for the SBA over the last few years have resulted in a shifting of the delivery cost to the small business owners and SBA's lending partners. So, instead of promoting capital access, the SBA's recent actions are exacerbating the problems for many small businesses and lenders.

It has long been known that SBA through its loan programs is the single largest provider of long-term loans for our nation's small businesses. Recent independent reports show that these loans are a vital economic development and financing tool.

The GAO recently did a report at the request of Senator Coburn. And the report found that we lend to minorities at three times the rate of conventional lending. 7(a) loans were larger and for longer-terms than conventional loans. Half of our loans were in under-served markets. Twenty-five percent of our loans went to start up in the year that they looked at. Today those are up over one-third of our loans are now to start-ups. And they also found that SBA and the Office of Management and Budget have overestimated our program subsidy costs.

Another report was from the Urban Institute. This one was commissioned by SBA. And they found that SBA programs are more effective than conventional loans in reaching minorities, women, and start-ups. SBA loans are a key financing tool to credit-worthy borrowers that, nevertheless, do not meet conventional underwriting standards. And SBA loans in under-served areas represent more than 36 percent of total loan approvals during the period reviewed.

Even though the GAO and the Urban Institute independently confirmed the importance and the benefits of the 7(a) program, loan volume is declining at an alarming rate.

With each passing week of this fiscal year, the problem has been getting worse. And in my testimony, there is a chart that shows the decline and how the decline is accelerating since the start of the fiscal year. October the 1st through February the 15th, we are down almost 15 percent in the number of loans and over 7 percent in the dollar of loans.

NAGGL has been actively communicating our concerns to the SBA regarding the declining loan volume and decreasing lender participation. Attached to my testimony are three letters. The first is dated December 17th and addresses our concerns about the excessive costs and effectiveness of SBA's lender oversight system.

And I would like to add that I need to correct that testimony. As of this morning, I was hand-delivered a response to that letter from the SBA. So my testimony recites that I have not received one, but as of this morning I have.

Our second letter is dated February the 25th and summarizes a survey of the NAGGL membership. NAGGL members clearly stated that the decline in 7(a) loan volume and lender participation is a result of decreased profitability of SBA lending due to lender fees and costs. SBA continues to state that fees are not an issue, even though their highest-volume participants say that fees are the top problem. I have not gotten a response to that letter yet, but that letter is only a week or so old.

Our third letter is dated February the 25th also and addresses our concerns relating to the proposed rule on lender oversight that was published in the Federal Register. We provided comments relating to the technical components of the proposed rule as well as overall concerns as to the effectiveness of the oversight program.

We are strong supporters of a strong lender oversight program. It needs to be accurate, beneficial, and cost-efficient for both SBA and its lending partners. And without mutual accountability and support, the mission of the SBA for America's small businesses cannot be provided through the lending community. And each of these three letters, again, is included in their entirety.

There are many factors involved with the decreasing profitability of 7(a) lending, lifted many of those on-site fees, off-site fees, delays in processing, lender purchase requests, lenders now being required to liquidate before they can request a guarantee being purchased. And the list goes on.

Without reasonable profits, lender participation in the program will decline, as is now happening. In addition, lenders' ability to reinvest in their outreach efforts to small business owners and expand their infrastructure to meet communities' capital needs is severely diminished.

At the very time the Federal Reserve is attempting to forestall a recession by reducing interest rates and by injecting liquidity in the banking system in an effort to persuade lenders to make credit available, the SBA's small business lending policies are being counterproductive.

My five minutes are up. I will save the rest for another time.

Chairwoman BEAN. If you want to just do a concluding statement, that's fine.

Mr. WILKINSON. Well, we have some concerns about lender oversight. And we can get into those in more details. I would say that our portfolio, even given our concerns about the oversight function at SBA, our portfolio is performing quite well.

The loss rate in the 7(a) portfolio is running at about a half percent per year. We can find from the FDIC in their quarterly banking profile reports that that is what commercial lending, commercial loan loss rates are running right now. So our loss rate is comparing favorably, but we would still like to see a more cost-effective, efficient, transparent lender oversight system at SBA.

[The prepared statement of Mr. Wilkinson may be found in the Appendix on page 48.]

Chairwoman BEAN. Thank you for your testimony.

I would actually like to start with Mr. Crawford with the first question that I have. As you know, the SBA has contracted with Dun and Bradstreet and Fair Issacs to create a loan-monitoring tool that forecasts the performance and/or risk of the portfolio. Can you tell us if this is how most financial institutions would monitor risk in their own portfolios?

Mr. CRAWFORD. That question might also be addressed to my esteemed compatriot Mr. Wilkinson since he is a banker. I suspect that that is not the case having talked to a number of banks with my own banking background way in the past. We did not attempt to forecast defaults in that manner.

Especially using a database like Dun and Bradstreet, my concerns about D&B are—and I have owned two small businesses, and I have had personal experience with reporting to D&B or not reporting to D&B, as may be the case.

When I got the D&B letter once a year, I generally threw it in the trash. I wasn't about to report my own financials to Dun and Bradstreet. There was no incentive to do that.

I know that D&B collects a lot of data on tax payments. I know they collect a lot of data on utility payments. I would not suggest that that database is on a par with just the financial data that my own certified development companies maintain on our borrowers where they are required, actually, through SBA regulation to get certified financials each and every year. That seems to be probably a better way to keep track of the likelihood of repayment of a debt through actual financials.

Chairwoman BEAN. All right. Thank you. And I guess I will do a follow-up with Mr. Wilkinson to get your perspective and also ask what sort of limitations you think that kind of system would have, particularly for larger SBA loans.

Mr. WILKINSON. Well, one of the problems we have with the current system—and I don't mean to pick on D&B. It's whatever contractor would happen to be sitting there—is the information is not transparent.

The SBA's lending partners were not included or asked input when the current system was established. And our big problem is we don't know what's in the model We don't know how the model was developed. We don't know what inputs are going into the model.

We are hearing that a lot of FICO scores are used. And, for my membership, they tell me FICO scores are fairly reliable up to loan sizes of about 150,000. Well, there is a significant number of our loans that are over 150,000.

And I believe Mr. Crawford's near entire portfolio would exceed that number, which leads you to a conclusion of, well, how reliable is this information. But without transparency, it's really hard to know.

I would also add that it is a very expensive system. This is a system that commercial banks do this kind of stuff all the time at a much, much lower cost.

Chairwoman BEAN. Thank you.

If I can ask you one other question? You talked about the survey of your members. And 67 percent of respondents stated that their institutions have tightened credit underwriting standards and 61 percent said they are seeing a decline in borrower loan demand. Is that what you would have expected or would you have expected the programs to pick up when the conventional market dries up?

Mr. WILKINSON. Well, typically what happens, we are somewhat counter-cyclical. So as difficult economic times hit, conventional lenders, you know, rein in their credit box. They shrink it down. And so there are more borrowers who would then fit into the SBA program. So in the past, we typically have an increasing loan volume at this time.

Chairwoman BEAN. I am going to ask one question of each of you, and then I am going to turn it over to my good friend from Florida. You have made a number of substantive recommendations to Mr. Zarnikow, who is endeavoring to make sure he can provide all the resources and tools for you.

But if I could ask you to just as sort of the top take-away, the number one thing you would most like to see him address, what would that be? We will come right on down. And then we can go to you and let you respond to that.

Mr. WILKINSON. Start down here?

Chairwoman BEAN. Yes. We will start with you.

Mr. WILKINSON. Boy. There are a number of items that we have shared with Mr. Zarnikow and his staff. But having recently done the survey, I can fall back on the responses of my members. And their number one response is that all fees, not just borrower fees, not just lender guaranty fees, but all fees associated with the program are too high. And it's hindering their participation.

Chairwoman BEAN. Okay. Thank you.

Mr. Betancourt?

Mr. BETANCOURT. I would just say maybe an acknowledgement that the program is going well. And I think the six years in a row of trying to eliminate a program that is meeting the target, in fact, and trying to raise the rates when we know that is going to be passed along to the borrowers and, quite frankly, an acknowledgement that the technical systems portion is really the key to getting paid back so that we can ultimately pay back the SBA.

Chairwoman BEAN. Thank you.

Mr. Crawford?

Mr. CRAWFORD. Interestingly, 504 doesn't have a rate issue with the SBA. That may be surprising, but I repeatedly argue with the CFO that our rates may, in fact, be a little too low. And I worry about that.

But if I were to ask Mr. Zarnikow for a couple of things, one, in spite of the comments I made about lender oversight, I believe it is absolutely vital that we have a solid lender oversight unit for the 504 program.

We have no FDIC. CDCs are regulated, are overseen by only the SBA because we are a creature of the SBA. So I say a strong lender oversight is a must. Our greatest crisis today because we are in a recession according to Mr. Buffett is probably the lack of resources committed to liquidations and recoveries.

Our liquidations clearly are going up. Our delinquencies are going up. If we don't get it under control and keep it under control at zero subsidy, you are going to see our fees begin to skyrocket. And next year I will complain about fees.

Chairwoman BEAN. Thank you.

Mr. Mercer?

Mr. MERCER. Thank you.

Well, Mr. Zarnikow represents the administration. The administration has refused to ask for authorization of the participating security program because OMB, the administration, has held that a participating security is not a debt for the purposes of the Federal Credit Reform Act; whereas, the administration, represented by Mr. Zarnikow, says it is a debt and requires participating securities to list it as a debt on their financial statements. How can they have it both ways?

I would point out that in the last recession, all venture capital shrunk by about 80 percent during—we're talking about equity investments shrunk by about 80 percent, I think, if I remember from my testimony correctly, during the recession; whereas, the participating security investments shrunk by I think 35 percent. I mean, it was the most constant source of equity capital during a recession, which we are now going into according to Mr. Buffett.

So I guess I would say, how can the administration do what it is doing with a straight face? It just is intellectually dishonest.

Chairwoman BEAN. So you would like to see some reconciliation of that. Thank you.

Hold on one second.

[Pause.]

Chairwoman BEAN. Okay. I think it is only fair to let Mr. Zarnikow respond. Most of this was obviously in the testimony that had been provided to you in advance, but I thought to maybe summarize a couple of things that you could respond to would be a good way to go.

Mr. ZARNIKOW. Sure. I mean, I think as we look at our priorities, there are probably three areas that I would look at and address. One is lender outreach, where we want to make sure that we are communicating with lenders, getting input from them. We have held a number of roundtables, go out and meet with lenders to try and encourage them to utilize our programs, and also to get input from them on how we can be better partners in utilizing our programs. We have held a number of roundtables, including the one this morning, and have six to eight planned across the country over the next 60 days or so.

I would also say one of my highest priorities is lender oversight and making sure we do have proposed regulations that are out there. We have gotten input from our industry trade partners, our trade associations. We are going to be going through our process of evaluating that input.

I would say on the lender oversight system, that there are definitely some misconceptions about that. That system was really designed as an oversight tool for the SBA, not for a tool for individual lenders to manage their portfolio.

These are all lenders who have other loans. The SBA typically is a small portion of their portfolio. And they have other tools to actually monitor their overall portfolio.

The lender oversight system is really designed to as we focus on our oversight efforts and provide that balance narrow the universe of the thousands of lenders we have to those where we see the highest risk in the program.

So I think there are some misconceptions about the system, although we are in the process of reprocuring as well. Clearly our centers are very important to all of our operations, whether it's loan origination, servicing, or liquidation. We are working on strategic plans related to each of our centers.

We are looking at each of the functions. What are the staffing requirements of those functions as we look at anticipated volume going out into the future?

We are also working on how can we be more effective and efficient as an agency utilizing technology, looking at policy changes or process changes, to make sure that we are appropriately staffed in our centers.

Chairwoman BEAN. I guess sort of following their summaries to you on the technical assistance, is that something that you will be addressing? And what about reconciling that definition of debt?

Mr. ZARNIKOW. On the microloan program, we are supporters of the microloan program. We do believe that it should be done on a zero subsidy basis. And that is what we are proposing in the 2009 budget.

As we look at technical assistance, we believe that there is a lot of technical assistance through our resource partners. And they service more than a million entrepreneurs each year. When you look at the microloan program, there are about 2,500 microloans that are made each year. So we believe that the resource partners that are out there provide appropriate ways to deliver technical assistance to the micro borrowers.

The microloan program with the technical assistance is a very expensive program. It costs over 85 cents on the dollar for each dollar that's loaned. We believe that there is a more efficient way to deliver that but support the program.

Chairwoman BEAN. You do think you can move back to a zero subsidy versus negative subsidy?

Mr. ZARNIKOW. Well, the microloan program actually we believe would be zero subsidy. The negative subsidy is on—

Chairwoman BEAN. That was the 504. That's right.

Mr. ZARNIKOW. —the 504 program. And as we look out, it is a very minor negative subsidy, about seven basis points. And, to put that into perspective on the average 504 loan, which is about a half million dollars, that negative subsidy is about $21 a year.

So we don't believe that that's a significant impact to the borrower. As was mentioned earlier, we are seeing increases in delinquency in that portfolio. And as we look out over time and to the 2010 budget, we would expect that that negative subsidy would go away. I believe it is important to have stability of that program.

Chairwoman BEAN. Thank you. And on the reconciling the different definitions within the administration?

Mr. ZARNIKOW. My understanding of that is that CDO and OMB have both made that determination, that it requires a 100 percent subsidy.

I am not an expert on federal budget law. I will let others address that further. We would say, though, that the participating securities program as it was in the past we think had some fundamental flaws in the structure of that program.

As was mentioned earlier, it did result in some pretty significant losses for the SBA. There were situations where investors made significant returns while at the same time the SBA lost money. So we think that the structure of that program was fundamentally flaws.

Chairwoman BEAN. Thank you.

Ranking Member Buchanan is now recognized for five minutes of questioning. No. You are up for as long as you want to question.

Mr. BUCHANAN. Thank you, Madam Chair.

Mr. Wilkinson, tell me a little bit of the profile of your association, the size banks? A billion assets or what's the typical profile? Where is the concentration of banks in general?

Mr. WILKINSON. The best way to explain that would be the makeup of my board. Let's see if I can remember this off the top of my head. We are eight small banks, five large banks, two CDCs, two service providers. I think I covered them all, but it runs the gamut.

We have the small community banks or small lower community banks that tend to be the largest concentration of members and then large institutions, the Wells Fargos, the JP Morgan Chases; and all of the small business lending companies that would participate in the program as well.

Mr. BUCHANAN. Do you have any community banks? Did you mention that? Do you have—

Mr. WILKINSON. Yes. That's the largest single membership category is community banks.

Mr. BUCHANAN. Okay. And you are mentioning today that just your volume is down. Decreased lender participation. What is driving that? I mean, I know one thing. Being in Florida, a lot of banks are also under a lot of pressure, their capital. And they are having to shrink a lot of things that they are doing. I'm just wondering how much of that is where they are looking at really their whole portfolio in general or asset portfolio. I am just wondering how much of that is—

Mr. WILKINSON. It would be a whole list of things.

Mr. BUCHANAN. Yes.

Mr. WILKINSON. You know, there are much more costs being passed on to lenders and borrowers today than in the past. It is a more difficult economic time. Lenders have pulled in their range and have a little tighter credit standards. And there have been issues in the marketplace, such as an inverted yield curve, that has made lending more difficult.

And there is a whole host of things that seem to have converged at one point. But clearly the fees and the costs are a major contributing factor.

Mr. BUCHANAN. You were talking about their lending criteria, tighter lending criteria. How much of that? How much of a proponent is that in what you said, do you think?

Mr. WILKINSON. Well, it probably shows up in the 7(a) program most in the SBA Express program, which is primarily a credit-scored product. And lenders as times became tough immediately changed their minimum credit score requirement to get conventional loans and for SBA loans.

So you will see that as a subset of the 7(a) program, our SBA Express program is down quite a bit, quite substantially, in terms of numbers of loans, about 20 percent.

Mr. BUCHANAN. What about lenders giving to established franchise companies? Is that a big part of the business, a small part so you've got someone that comes to you that—

Mr. WILKINSON. It's some. I do not know off the top of my head volume of lending to franchises. That is not a subprogram number I have seen in quite some time.

Mr. BUCHANAN. But you don't know if they are aggressively lending to people interested in buying a franchise? I was just curious.

Mr. WILKINSON. Well, each lender has their own business plan as to the types of businesses they would like to finance from community banks that tend to be financed, all of them, to sometimes we have specialty lenders that would gear their program towards, say, a franchise operation. I know that there are some SBA lenders with franchise lending divisions. But I don't know what kind of volume franchise lending would total in the program.

Mr. BUCHANAN. I was just curious.

Mr. Crawford, the CDC mentioned, what is the trend line on lending there? I think you covered it a little bit, but in terms of CDCs?

Mr. CRAWFORD. Well, we are—you mean for long-term?

Mr. BUCHANAN. Yes.

Mr. CRAWFORD. As I indicated, we are flat this year, which is kind of surprising. I have been through probably—I don't know—tony?—3 recessions in the last 18 years. I would have thought lending would still be running higher because, as Tony indicated, we are tending to be a counter-cyclical program.

The banks will turn to an enhancement vehicle like 504 fairly rapidly because they can lend 50 percent and still have a first lien position.

I suspect we are in the early stages of recession if you want to call it that. And I suspect that there are a lot of small businesses that are sort of pulling back their horns to wait and see how their own businesses, their own revenue streams are going to go. And then I think that we will probably see some resumption of some small business lending later in the year.

So I have real high hopes. That's why I indicated that I believe that we are going to run close to seven billion this year. And I am very concerned about next year because I think then our program's historic balance will kick in.

And I think you will see banks turn to 504. And I don't want to be sitting there with $7 and a half billion in authority. It would be pretty rough for us. I assume that the SBA would have to cut off lending at some point.

So I have high hopes that the program will get back on its historic growth pattern of 8 to 15 percent.

Mr. BUCHANAN. Mr. Mercer, on the SBICs, what has been the success rate in, say, the last five or six years of the SBICs?

Mr. MERCER. In terms of—

Mr. BUCHANAN. Venture funds, venture funds, small businesses.

Mr. MERCER. You're talking about the participating security funds?

Mr. BUCHANAN. Yes.

Mr. MERCER. Well, they stopped issuing licenses in 2004. So the program is ramping out of existence. There are about 160 funds still in existence. Fewer and fewer are being put into liquidations, ones that have gone into liquidation are the ones that had problems associated with the 2000 recession.

What will happen after September 30 of this year is anybody's guess because the funds that were licensed in, say, 2002, 2003, 2004 were given at least the implicit, if not explicit, promise of leverage equal in most cases to two times their private capital.

That leverage is going to be cut off, through no fault of those licensed SBICs, as of September 30 of this year. And no new leverage is being supplied. So it is really anybody's guess right now as to how those SBICs will be able to complete their business plans.

Many of them are seeking private sources of capital and trying to negotiate and have in many instances negotiated with SBA to buy out SBA's positions. Others will probably be unable to do that. And whether they will fail or succeed for the lack of capital they will be faced with, it is too soon to tell.

Mr. BUCHANAN. Mr. Betancourt, do banks do many of these loans that you do in the microloans or is there a reason why they don't do them or are they just too high-risk or what has been your history with that? I mean, people have come to you compared to using a conventional bank.

Mr. BETANCOURT. If I can just expand upon the subsidy issue that the administrator talked about? Quite frankly, the reason why banks are not doing this is because you can't money off these loans. You are going to spend $4,000.

In our case, every loan we spend 3-4 thousand dollars of our technical assistance time. We may earn $1,000 in interest. The loans are under 35,000. So if you have a $10,000 loan, you don't make enough interest to cover your costs.

Hence, this partnership with the SBA of trying to not subsidize but invest monies so we can help this entrepreneur, so that's number one. The economies just don't work for banks.

Number two, you have to help the client. There is a lot of work, credit repair, to understand the type of collateral that you need to use helping them with their business plan, et cetera, et cetera.

And the other thing is I think—and the SBA did this research a number of years ago, I haven't seen it in a couple of years—that there are borrowers that don't go to banks because of their fear of being turned down. And so there is a psychological factor that we have to work through. Again, you are not going to see it in any bottom line.

Mr. BUCHANAN. And you are just talking about that one thing. I didn't realize until I started looking at some of this. I think 50 percent of people that are looking for loans, banks or car loans, don't qualify for conventional financing. There are probably different numbers, but it's the number I've heard.

What percentage of the people you work with have where they can't probably go to a bank, you know, or can't get conventional finance would come to you or let's bad credit? I know that means a lot of different things. There is bad, and there is real bad. Your sense of—

Mr. BETANCOURT. The average credit score in our program a bank wouldn't even consider giving a loan. So I would say 90 percent of the loans a bank wouldn't even consider.

And we actually had a banker come in and say, "We want to buy your portfolio. We want to buy your loans." When they went through our portfolio, they saw all of our loans were being paid. But when they looked at the profile, given the credit score and the collateral that we were holding, they weren't interested. We get that every once in a while.

So that's more anecdotal, but I think that they just don't have the time, don't make enough money, and don't understand this type of lending. It's a real niche-type lending.

Mr. BUCHANAN. What has been your success rate in lending in the microloans area?

Mr. BETANCOURT. Our particular program is 97 percent payback. I would say nationally might be a five or ten percent charge-off. And, again, it's a one percent default rate because we put that reserve fund. The organizations are on the hook for any losses, not the SBA.

Mr. BUCHANAN. So you're saying of all the loans that you originate, you have a—what is the default rate?

Mr. BETANCOURT. Ninety-seven percent.

Mr. BUCHANAN. So you get 97 percent of people that pay the loans back?

Mr. BETANCOURT. I would say because, I mean, we look at microloan—

Mr. BUCHANAN. Security? What are they putting up, security or—

Mr. BETANCOURT. We're holding car titles, a second loan or a lien against their home, business assets. We pretty much do what a bank would do except the numbers and the economies are not as great. The equity might be zero, might be 100 percent financing that way. You might have equipment that's really not worth anything. But psychologically you tie them in. You help them.

One thing that I found interesting is that when our borrowers don't pay the bank if there's a problem, they'll pay us because we have a very tight relationship. We spend a lot of time with them. So there is a real relationship that we build with that entrepreneur. And then we obviously encourage them to pay the bank as well.

Mr. BUCHANAN. Thank you, Madam Chair.

Chairwoman BEAN. Thank you.

I am pleased to note Chairwoman Velázquez has joined us. And we recognize her.

Ms. VELÁZQUEZ. Thank you, Chairwoman, and thank you for holding this important hearing.

Mr. Zarnikow, welcome to this position. And welcome to the Committee. I am glad that you were able to make it. So I would like to address my first question to you.

You may know that Congress enacted two laws that created reduced-fee 7(a) programs. One was to promote energy-efficient projects. And the other was to assist veteran entrepreneurs.

When the administrator came before the Committee on the budget, he said that the SBA is not implementing these provisions because he claims they need an appropriation.

I have a copy of the two laws here. And I will ask if you can tell me, where is this, in any of these two laws, that there is an appropriation required to implement these two programs.

Mr. ZARNIKOW. My understanding is that that has been looked at and reviewed within the administration. And because these would be separate loan cohorts, there would be a subsidy that would be required in order to enact that portion of the bills.

I would say that we are moving forward to implement the other provisions of bills.

Ms. VELÁZQUEZ. But that would not require an appropriation?

Mr. ZARNIKOW. The other portions, that's correct.

Ms. VELÁZQUEZ. My question to you—and I have to say that when the administrator said that it required an appropriation, i was really shocked because I thought that he didn't read the language of the law. In these two laws, there is no requirement for an appropriation.

So even when you say that there is no funding and when I am saying that there is no funding required written into the law and you're maintaining that they need funding, my question is, given the fact that—and I think that you know that—the agency has the ability to transfer up to ten percent from a budgetary account to another account, my question is, will the SBA be willing to transfer up to ten percent from one of these accounts to another account, let's say, for example, the travel budget to partially fund the reduced fee loan program for veterans?

Mr. ZARNIKOW. You know, that is something that I would have to confer with my colleagues in the administration to be able to address. And we would be glad to respond back to your office.

Ms. VELÁZQUEZ. You know, we here in Congress, we go to the floor. And we are always saying how grateful we are for the men and women in uniform. Those men and women are returning back home from Afghanistan and Iraq. We passed this law to help them. Mr. Buchanan worked quite hard on this legislation.

So I hope that you will get back to us on that. And I will suggest, strongly suggest, that I think for the SBA, it should be more important to put money into the hands of veterans, rather than providing money for SBA's staff to go to conferences.

Mr. ZARNIKOW. We would be glad to respond to your question. I would also point out that last year we did roll out our Patriot Express product, which is specifically targeted towards veterans, reservists, and their spouses. And we have seen over 1,000 loans, made in that program for over 100. We do believe in supporting the people who are serving our country.

Ms. VELÁZQUEZ. I want to follow up on a point that was made by Mr. Crawford in his testimony. He stated that the SBA has not compensated any CDCs for their work liquidating defaulted 504 loans, even though the agency is supposed to do so.

Can you explain why your agency hasn't paid one single invoice from a CDC for their liquidation costs?

Mr. ZARNIKOW. We are in the process of working through an issue related to the 504 liquidation costs. We actually brought this to NADCO's attention in one of our many sessions that we worked together.

I would say that we are committed to paying the CDCs for the work that they have done in connection with liquidations that they have already completed related to liquidations. We are working through internally an issue. And we have committed to get back and have a response to that issue and how we are going to run that going forward.

Ms. VELÁZQUEZ. Did you request any money in the budget to do this?

Mr. ZARNIKOW. I would have to—

Ms. VELÁZQUEZ. No. So there wasn't any money requested by SBA to do this. My question to you is, if you didn't request any money, how do you think you could pay it back?

Mr. ZARNIKOW. I think, once again, as I mentioned, we are in the process of working through this issue internally and expect to have it resolved within the next couple of weeks.

I would also point out that we do have 504 liquidation staff in our Fresno and Little Rock centers who do work on 504 liquidations. And the delegated liquidation program really represents around ten percent of the CDCs. It's a subset of the liquidation effort.

Ms. VELÁZQUEZ. Mr. Crawford, I don't want to put you on the hot seat here, but when any of your members go through the process of liquidating and then go to the agencies and to the SBA and they don't get any money back, how do you think that will help your members?

Mr. CRAWFORD. Well, as you know, my members are small not-for-profit organizations generally. We have a couple of large CDCs but most are small. And they recognize that you can't have a loan program without having a recovery program to go with it.

And so they have stepped up to the plate. They worked with the 106th Congress. They worked with you. They worked with SBA and agreed that they would shoulder the labor burdens of doing these recoveries because the SBA, as you know, four years ago laid off all their portfolio management staff. So there was no one to liquidate and recover on 504s other than a few people that were left over in some of the field offices.

Now, the SBA has since added, whether the number is five or it's ten people, to the two liquidation centers. That is not the same as feet on the ground. If you have a default in Kansas City, someone that's in Fresno, California is not going to liquidate that loan. It's got to be somebody in Kansas City to do it, to go to the courthouse steps, to make the bid, to make sure the grass gets mowed, to make sure the locks get changed.

And so you have got to have a local presence to do that. And we have been trying to convince the agency for—I don't know—six years that that was needed. And we are willing to step up to the plate and do it.

But the servicing fees that CDCs make now are to service those loans. They are not to provide liquidations, workouts, and recoveries. And I will guarantee you that the whole industry cannot do this for free. There just isn't enough money. And so they have got to somehow be reimbursed for their direct costs or for their contractors. Otherwise the whole thing grinds to a halt.

Ms. VELÁZQUEZ. Thank you, Mr. Crawford.

Do you have any comments after that?

Mr. ZARNIKOW. I think I would repeat what I have said, which is this is an issue we are working through internally and developing a response.

Ms. VELÁZQUEZ. Mr. Zarnikow, when vendors go to the members to get paid, what do you think they are to going to tell them?

Mr. ZARNIKOW. I think I mentioned that we have committed to pay whatever has already been incurred through this process.

Ms. VELÁZQUEZ. Let me ask you. You mentioned how important lender outreach is for you. And, in fact, you held an average roundtable this morning, a lender roundtable this morning. And I was surprised to learn that you did not invite the National Association of Government Guaranteed Lenders to the roundtable. Can you explain to me why not?

Mr. ZARNIKOW. The lender roundtable was to work directly with some of the largest lenders around the country and some of our largest lenders. We have a very—

Ms. VELÁZQUEZ. Is it the National Association of Government Guaranteed Lenders?

Mr. ZARNIKOW. We have regular dialogue with the National Association of Government Guaranteed Lenders.

Ms. VELÁZQUEZ. What was the reason to exclude them if you are going to have a discussion about lending?

Mr. ZARNIKOW. We invited—

Ms. VELÁZQUEZ. Mr. Wilkinson, do you believe that you could have provided the SBA with some useful input if you were invited to that roundtable?

Mr. WILKINSON. Well, I don't know the entire content of the discussion today, but we do represent a large number of lenders. We do make a significant majority of their 7(a) loans and a majority of their 504 firsts.

I would say that I'm not aware of the attendee lists, although I am aware that two of the attendees that were there were on my board. I don't know who the other ones were.

Ms. VELÁZQUEZ. I think that it would be useful for the next roundtable that you conduct that you invite as many people, stakeholders so that you hear what you want to hear but also the critiques and contributions that could be made in terms of making the programs more efficient.

Thank you, Madam Chair.

Chairwoman BEAN. Thank you, Chairwoman Velázquez.

I wanted to just come back to Mr. Zarnikow. We talked a lot about the economy and the faltering economy and how the timing is really important. And so in your new job, you have tremendous priorities to address.

Given that there has been the credit crunch that we have heard about and tightening up of lender standards, have you given your lenders particular guidance on how to adjust their own criteria for SBA loans?

Mr. ZARNIKOW. A couple of things I would say relative to that are that you keep in mind as you look at the larger picture, although the number of loans year to date in the 7(a) program are down about 15 percent, the dollars are down about 6 percent compared to last year. Two thousand seven was a record year for lending in the 7(a) program. The year-to-date volume we are seeing is higher, really, than any year the past two years, which were record years. So, to put it in perspective, we are seeing a slight decline in lending volume coming off of record years.

As we talk with lenders out there, we hear a number of things, one of which is demand for loans is down. And we hear that as a very common theme as we talk to lenders, that they have seen fewer applications. The demand for loans is down.

As we talk to lenders, some of them have tightened credit standards. Others we talk to indicate they have not tightened credit standards. Where we have seen the biggest drop in volume in our program is in the smaller SBA Express program, which is primarily a credit-scored program. And what we have heard from some of the lenders in that program is that they have raised the bottom of their credit score box because what they found was the defaults were higher in that than they anticipated and, as a result, needed to adjust their credit standards.

As you know, our programs or our loans are really all made through lending partners. So we don't actually establish or set their lending criteria. We do monitor them from an oversight perspective, but they actually set their own credit policy.

Chairwoman BEAN. Okay. And, Mr. Wilkinson, did you want to comment?

Mr. WILKINSON. Yes, I did. I wanted to comment on the loan volume statistics. While it is true that 2007 might have had a slight number of loans on the increase, our dollar volume has slid steadily since fiscal year 2005, where we peaked with 15.2 billion in approvals down to 14.53 down to 14.29. And we probably at the pace we are on will be well below 14 this year. So we have had a steady decline now for four years in the dollar volume of lending.

Chairwoman BEAN. Thank you.

As you probably heard, the bells are ringing. Votes have been called again. I had just one last question for the SBA, and then we can adjourn. And I appreciate all of your efforts and your testimony.

The new lender oversight that you have talked about and to recoup the cost of monitoring the programs, you have added new fees. What do you think this new fee accomplishes for the SBA? And how does it benefit the portfolio since there has obviously been some rejection from others to that concept, and it is certainly limiting growth.

Mr. ZARNIKOW. Right. You know, obviously as we look at the mission of the SBA, it's to get capital to small businesses. And we balance that providing capital or getting capital to small businesses with having a healthy loan portfolio, which is important. So, therefore, we need to have an appropriate level of oversight.

We are increasing the amount of on-site visits that we are doing as part of that oversight responsibility and to be able to increase the number of oversight visits to over 200 this year really needs—we need to charge the on-site fees as well as to recoup the cost of the off-site monitoring that we do.

We did structure the fees so that over 80 percent of our lenders don't pay any fee at all. And over 90 percent of our lenders don't pay an on-site fee. So we have tried to manage that cost in a way that we call it a risk-based approach, where we have taken a look at where do we think the biggest risks are in our portfolio, where can we appropriately spend oversight dollars to manage that risk and provide a balance because we do understand that costs and fees are important.

Any time you have fees, nobody likes to pay fees or wants to pay fees. So that those are important. So we have tried to structure the program on a risk-based approach to really address where we see the biggest areas of risk in a portfolio.

Chairwoman BEAN. All right. Well, I thank you for your testimony and to all of you for weighing in on this important subject.

I ask unanimous consent that members will have five days to submit statements and supporting materials for the record. Without objection, so ordered.

This hearing is now adjourned.

[Whereupon, at 3:51 p.m., the foregoing matter was concluded.]

MELISSA L. BEAN, ILLINOIS
CHAIRWOMAN

DEAN HELLER, NEVADA
RANKING MINORITY MEMBER

Congress of the United States
U.S. House of Representatives
Committee on Small Business
Subcommittee on Finance and Tax
2361 Rayburn House Office Building
Washington, DC 20515-6315

STATEMENT
of the
The Honorable Melissa Bean, Chairwoman
Subcommittee on Finance and Tax
"Improving the SBA's Access to Capital Programs for Our Nation's Small Businesses"
Wednesday, March 5, 2008

Today, the Committee will examine the SBA's lending and investment programs and what steps the agency is taking to strengthen these initiatives. This hearing is timely given concerns about the economy, particularly the tightening of credit availability following the subprime mortgage fallout.

Access to capital is critical to small business, investment, growth and competitiveness. The current downturn, rising loan foreclosures, and a falling housing market, have caused financial institutions to tighten their credit standards. As a recent Federal Reserve survey confirms, more than 30 percent of lenders are raising their lending criteria for small firms.
For entrepreneurs, the rising cost of capital can cause many to forgo important purchases or expansion. This dampening effect has the potential to reduce entrepreneurial activity in the short-term, and further hinder economic growth.

In this environment, the SBA's lending and investment programs play their most vital role as there is an opportunity to provide capital to businesses that can no longer access affordable private alternatives. Small businesses are the nation's largest employer, and create 80 percent of domestic job growth.

Today's hearing seeks to determine what steps the SBA is taking to meet the needs of our nation's small businesses, making access to their loan programs easier. Recently, instead of providing crucial financing for small businesses, challenges facing the agency have resulted in reduced lender participation, lower loan volume to small businesses, and rising costs.

As we will hear today, many of these developments are in the agency's flagship 7(a) loan program. The dollar amount of 7(a) loans are decreasing and the number of financial institutions participating in the program are declining. A new 7(a) oversight fee is being added and even more fees are proposed for next year. These new costs come at a time when small businesses can least afford it. Last year, the House took action to address these concerns by passing HR 1332, a bill I sponsored.

At the same time, the agency's seed capital initiative – the SBIC participating securities program – remains closed, with little hope of seeing new life. This program is critical to small business growth, as sources of equity investment dry up quickly in economic downturns. Small, high-growth entrepreneurs are left with fewer options for financing. Again, solutions are on the table, including HR 3567, which creates a new start-up financing program and passed the House by a strong bi-partisan vote.

Further restricting access to capital, the administration proposed this year to increase the interest rates borrowers pay for Microloans. This will have the effect of raising the cost of loans for low-income borrowers at a time when other options are not available. HR 3020, which was sponsored by Ranking Member Chabot, takes steps to modernize the program – without raising the costs for low-income borrowers. This bill has also passed the House this session.

While the Committee is working to advance these proposals in the Senate, several new laws have recently been enacted to provide low-cost small business loans for veterans and energy efficient technologies. These types of initiatives show great promise to get capital in the hands of entrepreneurs – and we look forward to the SBA's near-term implementation of them both.

It is clear that SBA's lending and investment programs are an important tool for small businesses particularly in a faltering economy. As businesses face challenges securing affordable financing, a commitment to modernize and strengthen these initiatives will provide necessary alternatives. This hearing will call attention to the challenges facing the SBA's lending and investment programs so that Congress can act quickly to provide the resources and reforms needed for the growth and expansion of our community businesses.

U.S. House of Representatives

SMALL BUSINESS COMMITTEE

Subcommittee on Contracting and Technology

Wednesday, March 05, 2008

Opening Statement of Ranking Member Vern Buchanan

Improving the SBA's Access to Capital Programs for Our Nation's Small Businesses

I thank the Chair for yielding and for calling this hearing today on a matter important to millions of Americans. I would also like to extend my thanks to our witnesses who have taken time out of their schedules to provide this subcommittee with testimony today.

Today, too many small business entrepreneurs find themselves struggling in a volatile economy. They are entangled in government red tape, victimized by excessive litigation, or burdened by high taxes and health care costs...but all of this is made worse when small business cannot access the capital it needs to start or expand their enterprises.

The SBA 7(a) and the 504 lending programs are vital for the success of our nation's small businesses. It is evident that the number of lenders under the SBA's financing programs has decreased. Of course, some of that decrease is attributable to continued consolidation in the banking industry. But while the SBA is trying to increase participation in these programs, it also has taken steps that may have the opposite effect – by raising fees to lenders. This is an area I hope we can further address today.

The good news is we have made important strides in this committee over the past year. Chairwoman Bean sponsored, and I supported, bipartisan legislation aimed at reducing lending fees and increasing small business access to capital. H.R. 1332 improves and strengthens the SBA's successful 7(a) and CDC loan programs. This pivotal legislation enables the SBA's financing programs to operate without subsidy - and that's important. Should tax dollars be appropriated, the bill requires these additional funds be used to reduce borrower fees.

And finally regarding the SBA's investment programs....obviously, when a small business is short of needed capital, it faces the choice of accumulating debt in the form of loans or reducing its control of the company by selling stock to investors. But the SBA programs in attracting investment are in some cases unclear and even unhelpful. The business owner can be hit with an enormous tax penalty if he sells his equity, or a small business investment firm can itself tax the public treasury if unforeseen loopholes allows it to escape scrutiny.

The SBA was created to help small business compete in good times and survive in times of uncertainty. The essential purpose of these hearings is to determine whether existing programs are, as constituted, fair to both the borrower and the lender and to determine whether the cost of possible reforms do not unduly penalize the American taxpayer.

I look forward to working with Chairwoman Bean to ensure that the SBA's financing programs operate as efficiently and effectively as possible.

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Testimony of Eric Zarnikow
Associate Administrator for Capital Access
U.S. Small Business Administration
March 4, 2008

Chairwoman Bean, and members of the Committee, thank you for inviting me to testify about the U.S. Small Business Administration's FY 2009 budget for Capital Access programs.

I am Eric Zarnikow, Associate Administrator for Capital Access. I joined the Administration in December of last year, bringing more than 25 years of private sector business experience in accounting, finance and risk management. I am leading the Capital Access team in the many exciting initiatives and improvements planned for 2008. The budget request for FY 2009 reflects the President's commitment to America's small businesses and supports Administrator Preston's Reform Agenda to improve the Agency's services and make our programs more customer-driven.

Since 2001, SBA programs have continued to grow, while we have worked to streamline processes, make technological improvements and develop tools that increase our effectiveness. SBA continues to reach more small businesses through our business loan programs – and doing so while seeking to minimize the cost to the taxpayer. In FY 2001, the loan programs served about 42,000 small business borrowers. In FY 2007, the SBA provided funding to 89,400 small business borrowers in the 7(a) and 504 loan programs.

Through SBA's loan program and the delegated authority provided to participating banks, SBA has provided access to capital to small businesses and entrepreneurs who have had difficulty obtaining capital elsewhere. In FY 2007, SBA was able to reduce the cost to lenders of participating in SBA programs by increasing the efficiency of our processes and encouraging more lenders to make greater use of the capital access programs. The SBA completed all centralization of 7(a) and 504 loan processing functions, allowing for a more streamlined process that provides lenders with a better response time and improved services.

Over $300 billion of U.S. exports -- about 30% of total U.S. exports –are originated by small business. These exports generate thousands of jobs and billions of dollars of income for small business. International trade also exposes American small businesses to new ways of doing business- from both a technology and management perspective- all of which make them more competitive not only overseas, but domestically as well. In a rapidly globalizing economy, international trade is the best way for small business to participate in an expanding world economy. Where the U.S. has more free access to foreign markets, reducing the costs of doing business abroad, more small businesses can become global players and grow at a much faster rate. SBA's International Trade Program provided 2,968 loan guarantees to support small business exporters and provided counseling and training to lenders and borrowers. The SBA has aligned staff at U.S. Export Assistance Centers throughout the country and works closely with the Department of Commerce to provide services to small businesses seeking export assistance.

I am excited to be a part of Administrator Preston's management team. Our Capital Access team looks forward to continuing to work with the Committee to continue to improve access to our services by the small business community, through process improvements that are customer-focused, and outcome-driven. Our goal is to implement improvements that are employee enabled, efficient, transparent and effective. We are also focused on lender outreach and retention. We will continue to ensure capital access products and services are accessible to entrepreneurs in the nation's most underserved markets – those with higher rates of unemployment and poverty and lower rates of economic progress.

Highlights of the Budget Request

The President's FY 2009 proposal will support a total of $28 billion in lending authority for small business financing, which represents a 37% percent increase over actual business lending for FY 2007, through the 7(a), 504, Microloan and SBIC debenture programs. The proposal requests authorizations of $17.5 billion for the 7(a) program, $7.5 billion for the 504 program, $3.0 billion for the SBIC debenture program, and $25 million for the Microloan program.

The 7(a), 504 and SBIC program levels build on the continuing success SBA has achieved in its loan programs over the past five years. In 2007, we served more small businesses than ever before. In our two major loan programs, the numbers of gross approvals has increased by 99%, from 50,233 in FY 2002 to over 110,000 loans in FY 2007. 7(a) lending to minority-owned small businesses increased from 13,485 loans in FY 2002 to 34,114 loans in FY 2007. Women-owned business 7(a) lending experienced similar growth, from 10,364 loans in FY 2002 to 22,832 loans in FY 2007. These record level lending numbers are possible, in part, because of the zero subsidy policy that was adopted at the beginning of FY 2005. A recent Urban Institute study found that loans under the 7(a) and 504 programs were more likely to go to minority-owned, women-owned, and start-up businesses as compared to conventional small business loans. Moreover, the study shows that both the 7(a) and 504 programs are meeting demand among creditworthy start-up and minority-owned firms that meet credit elsewhere requirements.

In FY 2007 more than 2,000 small businesses benefited from over $707 million in SBIC investments. This SBA program increases the availability of venture capital to small businesses. SBA is working to increase our outreach efforts by participating in a number of forums to heighten the visibility of the SBIC program within all market segments.

The zero subsidy policy in the 7(a), 504 and SBIC programs has allowed the Agency to provide record levels of lending without the need for taxpayer-provided credit subsidy appropriations, while maintaining fee rates consistent with historical levels. This policy has provided certainty and stability for the 7(a) loan program, which both borrowers and lenders agree is crucial for this widely-used program, while reducing taxpayer costs.

Effectively managing agency resources devoted to SBA's lending activity is another key priority. Many improvements have been made over the past several years by centralizing lending functions. We have centralized 7(a) loan guaranty purchase and liquidation functions as well as 504 loan processing. As a result, 7(a) loan liquidations cost nearly $17 million less in FY 2007 than in FY 2003 even while our portfolio has grown markedly. Centralization allows for more consistent application of SBA's policies and procedures. It also allows the Agency to better monitor and manage its performance metrics.

As we continue to grow the loan portfolio, the need to provide sufficient infrastructure to manage our risk is more important than ever before. As such, we want to continue to strengthen and support the lender oversight and risk management functions of the Agency. To this end, SBA has increased staffing in those areas and has instituted additional measures to improve oversight. SBA has increased its on-site review of lenders from 55 in 2006 to 80 in 2007 and we currently plan to review over 200 in FY 2008. We have also made improvements to our lender portal that is a key oversight tool we use to monitor the portfolio and focus our efforts in the Office of Credit Risk Management. Lenders are provided access to the portal to receive information about the quality of their portfolio compared to their peers. These measures provide lenders feedback they need to proactively improve their SBA lending and program compliance. The measures also assist SBA in identifying those lenders that present the most risk to the SBA portfolio.

In addition, we are pursuing several measures to minimize the potential for fraud in our 7(a) and 504 loan programs. The Office of Credit Risk Management is looking at ways to leverage data analysis techniques to identify portfolio trends that may be indicators of potential fraud. Data developed from this effort will be referred to OIG for further investigation. Further, the Office of Capital Access is meeting with fraud experts in both the private and public sectors and with federal financial regulators to explore how SBA can further improve its fraud detection capabilities.

Despite record growth in 2007, there is a decline in the SBA year to date number of approvals for FY 2008. We have taken notice of this and are working with lenders and small businesses to ensure that we continue to meet the needs of the small business community. Since joining SBA I have met with lenders in New York, Atlanta and Denver. This morning SBA held a roundtable at the White House with lenders and Senior Administration officials. Meetings have been scheduled in another 6 cities around the country. Additionally, we have provided lenders with new loan products to help them reach specific sectors of the small business community and will continue to work with lenders to find ways to better serve small businesses.

Earlier this year the agency launched the pilot of the Rural Lender Advantage Initiative as a way to work with community lenders that are key to providing lending to economically distressed rural areas. This initiative simplifies application procedures and expands assistance to banks that do not regularly work with SBA.

Another product that we are very proud of is the Patriot Express Loan initiative. This product of our 7(a) program provides capital to veterans, members of the National Guard and Reserve and their spouses. This initiative was launched in June 2007 and almost $86 million have been provided to small businesses and entrepreneurs. This product provides loans up to $500,000 that can be used for most business purposes, including startup, expansion, equipment purchases, working capital, inventory or business-occupied real estate purchases. This new product offers support to military families by offering expedited approvals and a lower interest rate than other SBA financing options.

To expand capital to certain sectors of our economy in underserved communities, the Agency has also proposed a change to zero subsidy for our Microloan program. By changing the rate at which intermediaries borrow from the SBA from 3.77% (below the government's cost of funds) to 5.92% (1% above the government's cost), intermediaries will continue to receive a better-than-market rate of interest and SBA will be able to offer more loans to eligible intermediaries. This is particularly beneficial for businesses in those markets that can be reached best through microlenders.

The Agency is also seeking to vastly expand the number of outlets providing training to Microlenders by utilizing our technical assistance resource partners in 950 locations throughout the country, including the Small Business Development Centers and Women's Business Centers. By shifting Microloan technical assistance to our extensive network of existing resource partners and with the rollout of additional online technical assistance, SBA has the potential of tripling the potential outlets for microenterprise lending.

Conclusion

In conclusion, FY 2007 was a year of significant accomplishment for SBA's Capital Access Programs, and with this budget request, we look forward to continuing to build on this success. Today, SBA is helping more small businesses meet their financing needs than ever before.

Thank you for your time today. I would be happy to answer any questions.

National Association of Development Companies

STATEMENT

by

The National Association of Development Companies

on

The Small Business Administration

504 Loan Guaranty Program

Improving Access to Capital

Submitted to the

SUBCOMMITTEE ON FINANCE & TAX

COMMITTEE ON SMALL BUSINESS

UNITED STATES

HOUSE OF REPRESENTATIVES

by

Mr. Christopher L. Crawford
President & CEO

McLean, Virginia

March 5, 2008

The National Association of Development Companies (NADCO) is pleased to provide a statement to the House of Representatives Subcommittee on Finance & Tax concerning how to improve access to capital by small businesses.

NADCO is a membership organization representing the Certified Development Companies (CDCs) responsible for the delivery of the SBA 504 program. We represent more than 260 CDCs and more than 200 affiliate members, who provided more than 98% of all SBA 504 financing to small businesses during 2007, as well as many other small business programs and services in their communities. CDCs are for the most part not-for-profit intermediaries with a statutory mission of community and economic development achieved through the delivery of the SBA 504 and other economic development programs and services customized to the needs of their respective communities.

NADCO's member CDCs work closely with SBA and our lending partners to deliver what is certainly the largest and most successful federal economic development finance program in history (over two million jobs, $44 billion in authorized 504 loans and the leveraging of over $50 billion in private investment since 1986).

NADCO would like to thank Chairwoman Bean, Ranking Member Heller, Chairwoman Velazquez, Ranking Member Chabot, and the entire Committee, for continued support of the CDC industry and the 504 program. The Committee on Small Business has worked closely with SBA and our industry to ensure the availability of this valuable economic development program to small businesses for more than twenty years.

NADCO will provide comments today on the critical question of maintaining access to long term capital by small businesses during an increasingly volatile period in our economy. We will also comment on issues within SBA that will impact that capital access in the coming years.

504 FY 2009 Authorization:

We expect to end FY 2008 with about $6.5 billion in authorized 504 loans. The Administration proposes an authorization ceiling of $7.5 billion for FY 2009, the same as the current FY 2008 ceiling. While 504 program demand by small businesses has grown at an annual historical rate of almost 15%, demand has flattened during 2008. This appears to be due to the credit environment and to many small business owners holding back on planned expansions until they gauge the impact of a looming recession on their businesses.

Through three recessions, 504 has been a counter-cyclical capital access program. Even at the depths of a major economic shift, such as we face today, 504 has continued to meet the financing needs of small firms that are the ones who bring us out of recessions by continuing to create new jobs. With America facing perhaps its greatest credit crisis in history, we are treading on unknown ground today. We cannot risk shortchanging businesses that need capital by allowing 504 to come even close to running out of loan authority for the next two years. NADCO believes that a ceiling of $7.5 billion would increase that risk of running out of authorization during FY 2009.

Fortunately, the 504 program has been at "zero subsidy" since 1997. This means that there is absolutely no cost to the taxpayer for the program's authorization level. It is fully paid for by user and lender fees. Given that there is no cost whatsoever for 504 loans, we urge the Committee to increase the loan authority for FY 2009 to ensure that small businesses are not turned away by SBA. We request a minimum of $8.5 billion in loan authority, which is $1 billion more than the Administration's proposal.

Commercial banks are the primary source of long term capital for businesses in today's economy. History demonstrates that as banks become more wary of possible loan defaults in tough times, they react in two ways. First, they "shrink the credit box", and demand higher down payments, shorter terms, and apply higher interest rates to compensate for likely loan losses. Second, they turn to "credit enhancement" vehicles to decrease their risk of loss in the event of a loan default. This is where 504 comes in. Historically, during recessionary periods or periods of very slow economic growth, banks will bring more of their small business loan requests to CDCs and the 504 program as a means of decreasing their "loan to value" ratio by sharing the project debt risk with the SBA-guaranteed second mortgage.

This response in tough economic times is exactly why the program exists: to provide long term financing with reasonable terms to small businesses that continue to thrive and create jobs. Those jobs are what pulls our economy out of recessions, and 504 is a primary financing provider when other lenders have pulled back from the small business market.

NADCO believes that the 504 program may be needed over the next several years even more than in recent years as our economy slows. We urge the Committee to meet this potential need by increasing the authorization ceiling to $8.5 billion for 504 for FY 2009.

504 FY 2009 Subsidy & Fees:

As small businesses fall on hard times and income shrinks, SBA has taken an interesting approach to its calculation of the "subsidy" of 504 for FY 2009. With an outstanding loss rate of less than 3% historically, SBA has again slightly decreased the fees a borrower must pay for his 504 loan guaranty. NADCO appreciates SBA's conclusion that the program will likely maintain this track record.

However, SBA also decided to NOT decrease the program fees enough to simply fund its cost. Instead, the President's budget proposes to establish a "negative subsidy"; that is, knowingly charge borrowers MORE than is needed to fund 504 loan losses. Thus, the administration is proposing to impose a new tax on small business. While they expect this to be only about $1.4 million in excess fees, NADCO is appalled that SBA would seek more money than needed. We believe this action by SBA may even violate federal law.

SBA stated that they could not decrease the other existing fees due to statutory restrictions but in fact the agency could have done so by proposing a very small change in either the current fixed CDC fee or the first mortgage fee that the lenders pay. SBA refused to do so. We ask this Committee to seek passage of legislation to require a reduction of those fees in order to return this excessive cost to our borrowers. Such legislation would require the Administration to recalculate the 504 program subsidy and eliminate the negative subsidy prior to the beginning of FY 2009. The result would be lower costs for our borrowers.

504 Lender Oversight:

SBA recently issued a proposed regulation to define how it would implement and new lender risk management system and use it to enforce its policies on banks, SBLCs, and CDCs. Last week, NADCO submitted comments to SBA questioning the accuracy and applicability of this database and its procedures.

No one wants close oversight of the 504 loan process and CDCs more than the CDC industry itself. Operating at zero subsidy for many years, the cost of 504 to the government is zero, and the cost to our borrowers is incredibly low. We must all work continuously to keep these costs low through proper loan structuring, underwriting, servicing, and even liquidations of defaulted loans. All these processes must be overseen by qualified auditors who understand lending and credit from A to Z. We believe SBA has made substantial progress in creating an audit and review process that may one day rival the quality of oversight by FDIC.

However, this process of creating a completely new oversight unit has one potentially fatal flaw: its reliance on an unproven database that attempts to identify potential defaulting borrowers years before they actually default. This is tantamount to predicting the weather in Washington two years out!

There is no place in this critical oversight process for a system that attempts to "forecast" loan defaults if it is still unproven to the public. As any bank and borrower knows, this database has almost no real financial data in it; it consists mostly of vendor payment and tax data, and is used by almost no private lenders to assess business credit quality. Even SBA's own contractors, Dunn & Bradstreet and Fair Issacs, have admitted in public meetings and the press that their databases are not accurate when dealing with large loans or with pools of loans. Yet, because SBA has already spent untold millions for this system, it is seeking a new contract even as Congress, our industry and the banking industry question its viability.

NADCO urges Congress to step in and stop this contracting process. You should demand that SBA obtain unbiased outside verification by firms with both credit underwriting and financial modeling expertise of this risk management system. SBA must provide complete and transparent information to the public on its processes and accuracy. Two entire lending industries – CDCs and banks – should not be risk rated and regulated by a system that none of us believe to be accurate or transparent.

504 Loan Liquidation & Recovery Efforts:

As with any loan program, there are defaults by borrowers, and 504 is no exception. 504 will make over 10,500 loans this year. Even with good underwriting and close loan servicing, we would expect to see defaults by about 400 borrowers for our $30 billion portfolio. This would be a very good default rate of only 4%, and after liquidation of collateral, we would see a net loss of only about 2% for these loans.

However, as in previous recessions, we expect to see increasing defaults. Information from SBA indicates that defaults are up over the past three months, and are expected to rise further as delinquencies increase in the 504 portfolio.

Four years ago, SBA sought to begin cutting its operating budget, and laid off virtually all of its field staff responsible for recovery of 504 defaulted loans. Since that time, there has been no dedicated SBA staff working defaulted loans. Until SBA recently moved fewer than ten staff into liquidation jobs at the two servicing centers, it was truly "catch as catch can" for 504 defaults.

SBA continues to focus virtually all of its liquidation efforts on the 7(a) program, with an average loan of under $175,000, while ignoring 504, with an average loan size of almost $600,000. Further, almost all of the 504 loans are secured by "hard assets", ie, land and buildings, so the likelihood of a significant recovery for a 504 default would be high if a default is addressed quickly. Instead, SBA has paid lip service to the 504 default situation. Even when the Administrator approved additional positions for the liquidation centers, these jobs for the most part were never filled.

Amazingly, SBA appears to have turned an already difficult situation into a potential disaster for 504. The Congress passed, and SBA was supposed to implement, a program whereby CDCs could staff up or retain outside contractors to handle all 504 liquidation work in place of all those laid off SBA staffers. CDCs were to be compensated through the almost certain increase in net recoveries, as was demonstrated during a five-year liquidation pilot wherein the recovery rate increased by as much as 10% over the current rate for 504.

Unfortunately, it appears that someone forgot to tell SBA's budget planners that they needed to adjust the subsidy formula to account for the costs of reimbursing CDCs and contractors, as required by Congress and their own regulations! Working hard on existing recoveries, CDCs have completed a number of cases and returned to SBA collected funds for a number of defaults. As required by SBA regulation, these CDCs have submitted invoices for costs of contractors and internal staff work. To date, none of these invoices have been paid by SBA. When questioned, it was indicated there is a "policy problem" with these reimbursements. It appears the real problem is that SBA simply forgot to figure these cost reimbursements into BOTH their 2008 and 2009 budgets.

What's the result of this situation? CDCs will simply not be able to afford to continue working on loan defaults in the future—work will cease, the program's subsidy rate will increase, and future borrowers will pay for SBA's failure to account for needed fees. Nobody will track down defaulting borrowers and recover assets for the government on either existing loans (approximately 500) or on future defaults (approximately 35 per month).

So SBA appears to have ignored both Congress and its own new liquidation regulations. The end result will be plummeting recoveries and increasing future fees on 504 loans. With little or no recovery work by SBA, the expected net recovery rate of about 43% will fall rapidly, and government losses may well skyrocket both this year and for FY 2009.

NADCO asks this Committee to intervene in this situation immediately. There are only two options. First, SBA could be directed to either immediately hire, or to re-deploy trained staff to handle liquidations around the country. This would be tantamount to re-staffing some of those portfolio management positions they cut four years ago from the field offices. Alternatively, the Administration, Congress, and the CDC industry can work together to pass legislation to enable SBA to recalculate its subsidy model to include an allocation of some of the proceeds of loan recoveries to pay for the CDC and contractor labor needed to do this work.

No one, not the Congress, the Administration, or the CDC industry, wants to see fees increase due to increasing loan losses for 504. We believe SBA management wants to deal with this situation, but is hamstrung by the Federal budget process. The only way to break through this impasse is to pass legislation requiring SBA to recalculate its subsidy cost and fees. NADCO urges Congress to act now to deal with this situation. The almost certain alternative will be decreasing recoveries from defaults and rapidly increasing 504 program losses.

Conclusion:

Through 504, SBA provides the largest and most successful community and economic development program the Federal government has today. A study recently completed by California State University has concluded that, for every $1 of 504's program costs, it returns $94 in increased business revenues, and federal, state, and local taxes. Through the jobs our borrowers create and the business growth it fosters, 504 benefits employees, business owners, communities, and government at all levels. This takes place with no cost for the loan program to the U. S. taxpayer.

However, with a recession becoming more likely, it is imperative that Congress enable the CDC industry to meet the increasing needs for long term financing with low down payments for America's small businesses. To do this, we must work to keep our fees low. We must address the potential cost increases due to ineffective program oversight and lack of sufficient effort on recovery of defaulted loans. NADCO urges the Committee to address these problems through legislative direction to SBA immediately.

Again, we thank the Committee for its support of 504 and we look forward to another successful year of creating more jobs for our country.

NASBIC
America's Small Business Partners

Statement
of
Lee W. Mercer

National Association of Small Business Investment Companies
Suite 750
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Before The

United States House of Representatives
Committee on Small Business
Subcommittee on Finance and Tax

March 5, 2008

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Madam Chair and Ranking Member and members of the Subcommittee:

Thank you for the opportunity to appear today to give NASBIC's views on the important issue of "Improving the SBA's Access to Capital Programs for Our Nation's Small Businesses." Before turning to my recommendations, I would like to begin with some background information. First, there are three distinct parts that make up the whole of the SBIC program.

1. **The Debenture program.** The Debenture SBIC program has been in operation since the start of the SBIC program in 1958. It is the only leverage SBIC programs that is active today in terms of new licensees. Its purpose is almost exclusively to provide debt financing (generally subordinated debt) to U.S. small businesses. The program design is simple and effective: Debenture SBICs borrow money periodically by issuing SBA-guaranteed Debentures that bear low interest rates by virtue of SBA's guarantee. The loans augment SBIC private capital by a ratio that virtually never exceeds 2:1. The combination of private and borrowed capital is then available to invest in small businesses at higher rates of return—with SBA setting the maximum rates of interest that can be charged.

   SBICs pay interest on Debenture leverage semiannually, but the principal need not be repaid until the end of the debenture term, generally 10 years. The program is operating at a "zero" subsidy rate with no loss to the government. To the contrary, since 1992 the government has made a profit on the program from fees in the amount of $340 million. There are currently 132 Debenture SBICs managing $6.7 billion in committed capital resources. Debenture SBICs invested $1.3 billion in U.S. small businesses in FY 2007, a new high for the program.

2. **The Participating Security program.** The Participating Security program is the newest of the SBIC programs, but—unfortunately and unnecessarily—it is ramping down out of existence. The program was designed to promote equity investments in small companies. Started in FY 1994, it was the fastest growing of the SBIC programs through FY 2004. At that point the government stopped issuing Participating Security licenses because it was determined by OMB and CBO that Participating Securities are not "debt" securities, a necessity for the program to qualify as a credit subsidy program under the requirements of the Credit Reform Act. As a result of that holding, a dollar-for-dollar appropriation would be required for any new leverage. Given the intent that the SBIC program be a credit subsidy program and the scale of the program ($4.0 billion in leverage committed in FY 2004), a dollar-for-dollar approach is untenable. There are 160 Participating Security SBICs still operating (down from a high of 207 at year-end FY 2004. They invested $1.2 billion in FY 2007, down from a high of $1.6 billion in FY 2005. FY 2008 investments will likely total substantially less than $1.0 billion as more and more funds wind up their affairs.

3. **The unleveraged, bank-owned SBIC program.** Bank-owned SBICs were once a major factor in the SBIC program. Banks originally sought licenses to gain exception to laws that prohibited any bank from owning more than 5% of the equity of a portfolio company unless the bank was a licensed SBIC. However passage of the Gramm-Leach-Bliley Act in 1999 removed that prohibition for bank holding companies and bank-owned SBIC investments in small businesses are now largely insignificant. In FY 2007, bank-owned SBICs made just $123 million in investments, only 4.6% of all SBIC investments for the year. Some banks continue to invest funds in Debenture SBICs—generally for CRA credit—but the era of big bank-owned and operated SBICs appears to be over.

With that background, I will now turn to my recommendations.

1. **Improve the Debenture SBIC program.** The House Small Business Committee has already taken the lead in this area by securing passage by the full House of H.R. 3567, the "Small Business Investment Expansion Act of 2007." The bill contains two provisions that are particularly important to both greater growth in the program and greater potential for an individual SBIC to help a small business in which it has made an investment. Section 101 would substantially increase the amount of SBA-guaranteed leverage available to individual SBICs that can raise greater amounts of private capital—thus substantially increasing the amount of capital that would be available for investment in small business. Section 105 of the bill and would increase the amount of capital a single SBIC could invest in a single small business, thus increasing the ability of an SBIC to help its portfolio companies meet their growth plans. Both provisions would make the program more attractive to private investors and to private management teams, thus leading to greater growth in the program. Neither provision has been opposed by the Administration. Unfortunately, the counterpart Senate bill (S. 1662) is bogged down because of a "hold" place on the bill by a single conservative Senator opposed to the SBIC program as a whole. We hope that can be remedied prior to the adjournment of this Congress.

2. **Revive the Participating Security Program or Create an Alternative Equity Focused Program.** Warren Buffett, Chairman and CEO of Berkshire Hathaway Inc., has said: "by any commonsense definition, we are in a recession." That fact will make the availability of equity capital even more important to America's small businesses. Equity capital is the foundation upon which any company is built. A company's ability to raise senior debt and lines of credit—absolutely essential to business success—relates directly to its ability to raise equity capital. The Participating Security has been a great success in that regard:

   - Participating Security (PS) SBICs have made approximately $14 billion in equity investments in U.S. small businesses since the program's inception in FY'94.

   - PS SBICs were the most reliable source of equity capital for U.S. small businesses dealing with the fallout of the recession that began in 2000. All venture capital investments fell 83% between 2000 and 2003 according to Venture Economics. PS investments during that period—a total of $5.25 billion—fell just 23%.

   - Approximately 35% of all PS investments have been made in manufacturing companies.

   - Equity capital in the SBIC target investment range of $500,000 to $5.0 million is considered the most difficult to secure. PriceWaterhouseCoopers reported that there were $9.5 billion in investments in that range made in the years 2003 through 2005. PS SBICs investments were $4.1 billion (43%) of the equity capital for that period.

   - The $14 billion in PS investments since 1994 have led to the creation of an estimated 385,000 new jobs and $65 billion revenue within the U.S. small businesses that received Participating Security SBIC financing. (These estimates are based on a 2001 National Venture Capital Association study that found that one sustainable job is created for every $36,000 in venture capital invested in a small business and that every $1.00 in venture capital leads to $4.75 in a portfolio company's revenue.)

Unfortunately, the PS program lays moribund, a victim of a 2004 OMB and CBO decision that the SBA-guaranteed "Participating Securities" issued by PS SBICs to raise capital to augment their private capital do not qualify as "debt" securities eligible for appropriations subsidy scoring under the requirements of the Federal Credit Reform Act of 1990. The CBO decision, 10 years after the program had been in operation as a subsidized program (that carried a "zero" subsidy rate for many years), meant that dollar-for-dollar appropriations would be required to continue in the program's existence. The decision has destroyed the PS program.

The destruction of the PS program is not necessary. The 2004 OMB / CBO holding was wrong and should be corrected. Once the OMB / CBO holding is reversed through legislation, the PS program (or a successor program) will again be a subsidized program and appropriate changes can be made in the enabling legislation to reduce the subsidy rate to either "zero" or a positive rate acceptable to Congress. Perhaps the easiest change, and the one with the greatest impact on the subsidy rate, would be to limit the leverage-to-equity ratio of any equity focused SBIC program to 1:1—a 50% reduction in the 2:1 limit allowed pursuant to the current PS legislation.

Analysis of CBO's Erroneous Decision: The Definition of "Debt." The Federal Credit Reform Act of 1990 does not define the term "debt." Absent a definition within the statute itself statutory terms are subject to the "Plain Meaning" rule of statutory construction. See Supreme Court case Caminetti v. U.S., 242 U.S. 470 (1917). According to the plain meaning rule, absent a contrary definition within a statute, words must be given their ordinary meaning. If the words are clear, they must be applied.

The term "debt" is defined in many ordinary contexts.

"A duty or obligation to pay money under an express or implied agreement." Merriam-Webster On-Line Dictionary.

"General name for money, notes, bonds, good, or services which represent amounts owed." New York State Society of Certified Public Accountants.

"The term debt means liability on a claim." Federal Bankruptcy Law, 11 U.S.C. 101(12).

By reference to these definitions, all supported by the "Plain Meaning" rule of statutory construction, both generally accepted accounting principles (GAAP) and SBA-promulgated SBIC regulations require that Participating Securities be characterized as debts on the financial statements of all PS SBICs. It is only CBO and OMB that erroneously disagree with the characterization of Participating Securities as debt for accounting purposes.

Analysis of Relevant Sections of the Participating Security Program Enabling Legislation. The Small Business Investment Act does not define the term debt. However, it is clear from the wording of three provisions of §303 that Congress intended Participating Securities to be a debts.

- "Participating securities shall be redeemed [repaid] not later than 15 years after their date of issuance for an amount equal to 100 per centum of the original issue price plus [contingent interest if any is due under the formula provided]." §303(g)(1).

The above section creates an unambiguous obligation to pay money on the claim created by a participating security.

- "The only debt other than leverage [the amount of money raised by issuance of SBIC participating securities or debentures] obtained in accordance with this title which any company issuing a participating security under this subsection may have outstanding shall be temporary debt ...." §303(g)(5).

The phrase "only debt other than leverage" is unambiguous. Congress considered both participating securities and debentures (the only securities that can be used to raise "leverage") to be debts. The term "leverage" is defined by the American Heritage Dictionary to mean "credit or borrowed funds used to improve one's speculative capacity ...," i.e., a debt.

- "All fees, interest, and profits received and retained by the Administration under this section shall be included in the calculations made by the director of OMB to offset the cost (as the term is defined in section 502 of the Federal Credit Reform Act of 1990) to the Administration of purchasing and guaranteeing debentures and participating securities under this Act." §303(j).

This section makes clear the congressional intent that the securities issued under the program would qualify for subsidy scoring pursuant to the requirements of the Federal Credit Reform Act. Only if qualified could the receipts be used to offset the costs. The section is an explicit directive that the securities and the receipts realized by the Administration from them are qualified under the Federal Credit Reform Act. Since the Federal Credit Reform Act was passed eight years prior to the legislation creating the PS program, it must be assumed that Congress knew the law. If it had not intended participating securities to be debts for the purposes of the Federal Credit Reform Act it would not have made the receipts deductible from costs in §303(j). OMB and CBO should have given deference to this clear congressional intent.

Legislation Required To Revive The PS Program or Create a New Equity Program. To revive the PS program all that would be required is to amend the last sentence of §303(g) of the Small Business Investment Act—the section that creates participating securities—to read as follows, the new text appearing in italics:

"Participating securities guaranteed under this subsection *shall be considered debt securities for all purposes related to the Federal Credit Reform Act of 1990 and* shall be subject to the following restrictions and limitations, in addition to such other restrictions and limitations as the Administration may determine:"

Amending the SBIA as suggested would correct the erroneous OMB / CBO holding and again make the Participating Security program an effective partner in providing scarce equity capital to U.S. small businesses. As indicated above, an additional amendment to reduce the leverage to equity ratio from 2:1 to 1:1 would likely again reduce the subsidy rate to zero.

An alternative to the above would to create a new "Participating Debenture" program by enacting legislation such as that proposed by NASBIC in 2005.

Thank you again for the opportunity to appear today to address the issue of improving the ability of America's small business to access capital through SBA programs. It is an issue that is critical to economic growth in our country.

Lee W. Mercer

Lee Mercer is president of the National Association of Small Business Investment Companies and has served in that capacity since 1996. Before joining NASBIC he had held positions in both the private and public sectors. He had been a partner in a New Hampshire law firm, a government program manager for Digital Equipment Corporation, and president of two small, privately owned companies. In government he had served as legislative director and counsel for former U.S. Senator Warren Rudman (R-NH) and as a deputy undersecretary of commerce at the Department of Commerce during parts of both the Ronald Reagan and George H. W. Bush administrations. While with Senator Rudman, Lee was the primary manager of the 1982 legislation that created the Small Business Innovation Research (SBIR) program. Lee received his BA degree from Dartmouth College and his JD and LLM degrees from the Boston University School of Law.

HOUSE SMALL BUSINESS SUBCOMMITTEE ON FINANCE AND TAX

Hearing on

Improving the SBA's Access to Capital Programs for Our Nation's Small Businesses

March 5, 2008

Written Statement of
Daniel Betancourt, President & CEO
Community First Fund
Lancaster, Pennsylvania

Dear Chairwoman Bean, Ranking Member Heller, and other members of the Subcommittee:

My name is Daniel Betancourt and I am President and CEO of the Community First Fund in Pennsylvania. Community First Fund's mission is to create lasting economic growth in the communities that we serve. I am also the Board Chairman of the Association for Enterprise Opportunity (AEO), the national leadership organization for microenterprise development organizations across the country.

I appreciate the opportunity to discuss the importance of the SBA Microloan Program and how it differs from the SBA 7(a) loan guaranty program. As an SBA Microloan Intermediary since 1992, I know this program is of great assistance to the entrepreneurs within the 13 counties in central Pennsylvania that my organization serves. Entrepreneurs served by the Microloan Program are not served by the private sector, nor do they qualify to receive SBA guaranteed loans like 7(a) or CommunityExpress. As a former banker, I know that traditional banks will simply not lend to these borrowers, with or without a SBA guarantee.

Community First Fund also uses the 7(a) program. It is a good program, but it serves a different type of borrower. I simply can not use the 7(a) program to help the people that I assist through the Microloan Program.

The Microloan Program is unique in that it provides both loan capital and funds for technical assistance and business training. The loan capital is offered at a lower than market rate, which allows my organization to make loans that are less costly and easier for our local entrepreneurs to pay back. This enables the businesses to grow more quickly and hire additional employees sooner.

Many of the entrepreneurs that we assist have had trouble accessing capital through commercial banks and also need substantial training and technical assistance to succeed in launching and growing their businesses. The Microloan Program has enabled us to help these entrepreneurs, who have been very successful when given the assistance that they need. Without the assistance that we are able to provide for them, most of these small businesses would not be able to get off the ground or to succeed for very long.

From the perspective of a practitioner, the Microloan Program is a program that really works. In order to carry out our mission to assist entrepreneurs, we need to be able to access low-cost capital for our loan pool and to access funds to cover the costs of the training and technical assistance that we provide to the entrepreneurs. The Microloan Program provides funding for both components of our work.

The Microloan Program has been a very good use of federal dollars. It has a low default rate, since the combination of training and technical assistance with lending has insured that the entrepreneurs are well prepared prior to receiving their loan funds. We also work closely with the entrepreneur after the loan is made, so that any problems that arise can be dealt with before they become serious. This program would not work nearly as effectively if the technical assistance was not provided or if it was provided by someone else. The intimate knowledge of the business that we gain by providing both the loan capital and technical assistance is one of the key strengths of the program and should not be underestimated.

I want to comment on the President's proposal to eliminate all funding for Microloan lending capital and technical assistance, and to raise the interest rate on the funds borrowed by Microloan Intermediaries. While the President has not recommended terminating the Microloan Program, for the second year in a row he proposes the elimination of all funding. This would make the program unworkable for Microloan Intermediaries and the entrepreneurs they serve.

The proposal to eliminate funding for loan capital would require the interest rate on Microloans be increased, which would make this program much less appealing to microenterprise development organizations such as mine. The value of the program is that it allows Microloan Intermediaries to keep interest rates down and provide their borrowers with affordable financing. By raising the interest rate for the Intermediaries, they will be forced to pass on this increased cost by raising interest rates paid by microentrepreneurs, which will create an economic hardship for them and make it more difficult for them to grow their businesses. This would lead to fewer jobs created and fewer tax dollars paid. This strategy is counter to the original reason that Congress created the Microloan Program.

The President also wants to eliminate the technical assistance portion of the program. As a practitioner, I know that this proposal will make this program unworkable. The reason that the Microloan Program has been very successful over the years has been this pairing of technical assistance funds with loan capital. This combination has led to a loan default rate of less than 1%, the lowest of any SBA lending program. Taking away the technical assistance dollars and asking other SBA technical resource partners to take on the technical assistance function will disrupt this winning formula and is likely to increase the default rate. This is a cost-effective program that has been very successful at creating and retaining jobs in communities throughout the country, while maintaining a very low default rate.

In contrast, the entrepreneurs that my organization helps through the 7(a) program have larger businesses that require larger loan amounts, have more collateral, higher credit scores, and have more business experience.

My hope is that some of the entrepreneurs that we are currently helping through the Microloan Program will one day grow to the point where they will be in a position to use the 7(a) program. Right now they are not.

The Microloan and 7(a) loans are two worthy programs, which are complementary and absolutely not duplicative. We need to have both of them available to fully serve the diverse needs of the entrepreneurs in our communities.

Over the last fifteen years Community First Fund has made a measurable impact in the region. Its service area has expanded from Lancaster County to a thirteen-county region in south central Pennsylvania which has a population in excess of 3.5 million people. Since its founding, Community First Fund has made over $11.5 million in loans. During its first ten years, Community First Fund made approximately $1 million in total loans; however, during the last fiscal year alone, Community First Fund made 126 loans totaling over $3.2 million dollars and brought Community First Funds total current loan portfolio to over $5.2 million. Also in the last fiscal year, Community First Fund provided services, including training and counseling, to more than 4,000 individuals.

This growth has led to the creation or retention of over 800 jobs in the past three years, and the development of 73 new affordable housing units. As a result of its new efforts in the area of commercial real estate loans, Community First Fund financed the development of over 34,000 square feet of commercial space, primarily in lower income urban neighborhoods. In the next four years, Community First Fund's strategic efforts will continue this growth and will create or sustain over 1,800 jobs, over 80 new affordable housing units and over 375,000 square feet of commercial real estate. Community First Fund anticipates the growth of its loan portfolio to $25 million by 2010.

Thank you for this opportunity to testify and I look forward to answering your questions.

NATIONAL ASSOCIATION
OF GOVERNMENT GUARANTEED LENDERS

"Improving the SBA's Access to Capital Programs for Our Nation's Small Businesses"

Testimony before the Subcommittee on Finance and Tax of the House Committee on Small Business

March 5, 2008

Submitted by
Anthony R. Wilkinson, President & CEO
National Association of Government Guaranteed Lenders, Inc.
215 East 9th Avenue
Stillwater, OK 74074

NAGGL Gets It.

NATIONAL ASSOCIATION
OF GOVERNMENT GUARANTEED LENDERS

Chairwoman Bean and members of the Subcommittee, my name is Tony Wilkinson. I am president and chief executive officer of the National Association of Government Guaranteed Lenders (NAGGL), a trade association of approximately 700 banks, credit unions, non-depository lenders and service providers who participate in the Small Business Administration's 7(a) loan guarantee program. NAGGL members generate approximately 80% of the annual SBA 7(a) loan volume.

These are difficult times for the participants of SBA loan programs. Lenders and small business owners are facing uncertain economic conditions, decreasing profitability and rising expenses. Small business owners need access to capital to succeed and the SBA offers the primary vehicle for delivering much needed, long-term capital. However, SBA loan volume is declining. The pool of active participating lenders is shrinking. Lender fees and costs continue to rise. The Administration's FY 2009 budget request calls for more cuts that will cumulatively total 28% since 2001. This means SBA will have proportionately taken more budget cuts than any other federal agency. Unfortunately, the budget cuts for the SBA have resulted in a shifting of the delivery costs to the small business owners and the SBA's lending partners. Instead of promoting capital access, the SBA's recent actions are exacerbating the problems for many small businesses and lenders.

NATIONAL ASSOCIATION
OF GOVERNMENT GUARANTEED LENDERS

Why the SBA is Essential

It has been long known that the SBA, through its 7(a) and 504 loan programs, is the single largest provider of long-term loans for our nation's small businesses. Recent independent reports show that these loans are a vital economic development and financing tool.

The GAO (at the request of Senator Coburn) and the Urban Institute (at the request of the SBA) recently reviewed the 7(a) loan program. GAO found that 7(a) loans went to certain segments of the small business lending market in higher proportions than conventional loans. For example, 28 percent of 7(a) loans compared with an estimated 9 percent of conventional loans went to minority-owned small businesses from 2001 through 2004. In addition, 25 percent of 7(a) loans went to small business startups, while the overall lending market served almost exclusively established firms (95 percent).

Elsewhere the GAO reports, "... SBA does track loans that go to firms in areas it considers 'underserved' by the conventional lending market. SBA defines 'underserved' by one of these federally-defined areas: Historically Underutilized Business Zone, Empowerment Zone/Enterprise Community, low- and moderate-income census tract (median income of census tract no greater than 80 percent of the associated metropolitan area or non-metropolitan median income), or rural as classified by the U.S. Census. Using this measure, SBA's analysis found that 49 Percent of 7(a) approved loans and disbursed in fiscal year 2006 went to geographic areas that SBA considered 'underserved' by the conventional market."

Additionally, the GAO reported the following:

- 7(a) loans were larger and for longer terms than conventional loans;
- 25% of 7(a) loans went to startups; and,
- SBA and OMB have overestimated program subsidy costs.

The Urban Institute, a non-partisan group, completed a study commissioned by SBA, and found the following:

- SBA programs are more effective than conventional loans in reaching minorities, women and startups;
- SBA loans are a key financing tool for creditworthy borrowers that nevertheless do not meet conventional underwriting standards; and,
- SBA loans to businesses in underserved areas represented more than 36% of total loan approvals.

The SBA concurs that "these reports validate our essential role in getting capital to underserved communities and our success in doing so".

Accelerating Decline in SBA Loan Volume

Even though the GAO and Urban Institute independently confirm the importance and benefits of the 7(a) program, loan volume is declining at an alarming rate. With each passing week of this fiscal year, the problem has been getting worse.

Accelerating 7(a) Loan Volume Decline

FY 2007 versus FY 2008

Date	#	$
10/1/2007	---	---
11/02/2007	- 7.8%	2.2%
11/23/2007	-12.0%	-4.1%
12/31/2007	-12.4%	-4.1%
1/25/2008	-14.0%	-5.7%
2/08/2008	-14.4%	-6.8%
2/15/2008	-14.8%	-7.1%

NAGGL has been actively communicating our concerns to the SBA regarding the loan volume decline and decreasing lender participation. Our first letter, dated December 17, 2007, addresses concerns about the excessive costs and effectiveness of SBA's lender oversight system. To date, SBA has not responded to our letter.

The second letter, dated February 25, 2008, summarizes a survey of the NAGGL membership. NAGGL members clearly state that the decline in 7(a) loan volume and lender participation is a result of "decreased profitability of SBA lending due to lender fees and costs". The SBA continues to state that fees are not an issue—even though their highest volume participants say that fees are the top problem. The SBA has yet to respond to this letter.

The third letter is dated February 25, 2008 (and supplemented with additional comments on February 29, 2008) and addresses concerns related to the proposed rule on Lender Oversight as published in the Federal Register (October 31, 2007, Vol. 72, No. 210, 61752 ff). NAGGL's comments focus on the technical components of the proposed rule, as well as overall concerns as to the effectiveness of the oversight program. We have always agreed that a strong lender oversight program is important—provided that it is accurate, beneficial and cost-efficient for both the SBA and its lending partners. Without mutual accountability and support, the mission of the SBA for America's small businesses cannot be provided through the lending community.

Each of these letters, in their entirety, are attached and made part of this testimony.

Declining Lending Participant Profitability

There are many factors involved in the decreasing profitability of 7(a) lending. The following are examples of how the SBA has transferred direct and indirect program costs from its federal budget to its lending partners:

- Onsite and offsite lender review fees;
- Delays in SBA's processing of lenders' purchase requests ;
- Lenders are now required to liquidate chattels prior to requesting that the guaranteed portion be purchased;

- Proposed increase in ongoing lender guarantee fee back to the statutory maximum of 0.550%;
- Proposed new secondary market fee; and,
- Post-purchase reviews, some as old as 6 to 7 years.

Without reasonable profits, lender participation in the program will decline, as it is now. In addition, lenders' ability to reinvest in their outreach efforts to small business owners and expand their infrastructure to meet the community's capital needs is severely diminished. At the very time the Federal Reserve is attempting to forestall a recession by reducing interest rates and by injecting liquidity in the banking system in an effort to persuade lenders to make credit available, the SBA is implementing counterproductive small business lending policies.

Concerns regarding SBA Lender Oversight Program

The SBA 7(a) program is performing well. During a presentation at NAGGL's most recent annual convention, an SBA representative acknowledged that the loss rate in the 7(a) portfolio is running about 0.5% per year. The FDIC *Quarterly Banking Profile* showed that banks had commercial loan losses of 0.5% on an annualized basis for the third quarter of 2007. For the fourth quarter, that number jumped to 0.83%. The performance of the 7(a) portfolio compares very favorably to conventional lending.

Even so, the SBA is asking the lending industry to pay for a lender oversight model provided by outside contractors. The model is not transparent, provides very little useful information for lenders, and has not been independently reviewed or validated by the GAO or another third party.

The basis for this model is a credit-scoring process. In a recent *BusinessWeek* article, the chairman of Fair-Isaacs, one of the contractors on the SBA project, noted that credit-scoring is not a valid tool to rate entire portfolios. From a presentation at one of our recent annual conferences, a Dun and Bradstreet representative explained that the predictability of the credit score diminishes as loans exceed $300,000. Conventional commercial lenders rarely (if ever) use credit scoring for loans in excess of $150,000; their experience tells them that accurate predictability declines beyond the $150,000 level. Yet the bulk of the dollars in the 7(a) program, and nearly all of the dollars in the 504 program, are from loans greater than $150,000. In the minds of our lenders, the accuracy of the lender oversight information is questionable and the benefit associated with the fees has not been adequately justified by the SBA.

We believe that unless the reasonable profitability of 7(a) lending is restored, banks will be reluctant to sustain or expand their SBA lending activity and the program will fail to reach the needs of small business in this tightening credit environment. We respectfully request that, at a minimum, the agency be directed to indefinitely suspend its imposition of lender oversight fees. Such suspension should be permanent—or at least remain in place—until a comprehensive review of the agency's lender oversight program is concluded. We do not believe this fee suspension will in any way affect the quality of SBA's oversight efforts.

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NAGGL Legislative Request

In an effort to stop the decline in 7(a) volume and decrease in lender participation, NAGGL once again asks for your support of the following items:

- Increase maximum 7(a) loan size to $3 million;
- Increase maximum guarantee to $2.25 million;
- Use of the alternate size standard used in the 504 and SBIC programs;
- WAC (weighted average coupon) Pools;
- Rate Basis Other Than Prime (5-Year Constant Maturity Treasury); and,
- Suspension of Lender Oversight Fees.

NAGGL believes that the proposed changes are vital to the long-term prosperity of the SBA business loan program. Without implementation of these changes, NAGGL believes that the program will continue to become cost prohibitive for lenders and small business owners. Over the previous three years, NAGGL has requested on multiple occasions that the SBA address the last four items of the association's legislative request through regulations. To date no action has been taken on these steps that would make the 7(a) loan program more efficient and cost effective. The Committee's help in making these necessary changes statutorily would be greatly appreciated.

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SBA lending partners desire to continue meeting the capital needs of America's small businesses. In these trying economic times, the importance of the SBA program is significantly enhanced. In order to deliver the SBA product, reasonable policies and procedures need to be implemented that benefit all parties involved. To reduce the cost to the SBA at the expense and burden of its lending partners does not appear to be a reasonable compromise.

I appreciate the opportunity to testify today on the SBA 7(a) program and provide suggestions for improving the public-private partnership that exists to deliver much needed capital to America's small business borrowers. Thank you for your continued support of this vital economic program.

Attachments – NAGGL's recent communications to the SBA:

December 17, 2007	Letter to Administrator Preston
February 25, 2008	Letter to Administrator Preston (results of NAGGL member survey)
February 25, 2008	Comment Letter on Proposed Lender Oversight Program Rule RIN No. 3245-AE14
February 29, 2008	Supplemental Comments on Lender Oversight RIN No. 3245-AE14

NATIONAL ASSOCIATION
OF GOVERNMENT GUARANTEED LENDERS

December 17, 2007

The Honorable Steven Preston
Administrator
U.S. Small Business Administration
409 3rd Street SW
Washington, DC 20416

Dear Administrator Preston:

NAGGL is concerned about the deterioration in the financial markets and its impact on the economy and small business. We believe that a nationwide credit crunch is underway as lenders tighten lending criteria and reduce credit availability. This situation has been precipitated by the subprime lending crisis, an infection that is spreading to SBA's 7(a) loan program. I would like to ask your assistance in assuring the continued availability of the 7(a) program that is so critical to the U.S. economy overall.

As you know, year to date 7(a) loan volume is down 11 percent in numbers and 2 percent in volume. In these uncertain economic times, the SBA and its active lending partners are in a position to help alleviate the credit crunch and provide economic stimulus and assistance to small business. Based on SBA and FDIC data, SBA's 7(a) loan portfolio is performing as well as bank conventional small business loan portfolios. But senior management decisions at lending institutions to cut operating costs and curtail credit availability in response to the subprime situation have impacted the 7(a) program.

The overall financial health of the banking industry is detailed in the FDIC's quarterly banking profile released November 28. The FDIC report notes that nearly half of all commercial banks had lower third quarter profits from the previous year. Among other findings, the FDIC notes that the industry ROA fell to the lowest level since the 4th quarter of 2002; loan loss provisions surged to a 20-year high; and regulatory capital rations fell to six-year lows.

These facts are driving management decisions, and while declining 7(a) loan volume is the most important symptom, it is not the only symptom. Even lenders that have managed to increase or maintain their level of 7(a) lending activity report that they are suffering. Last week a major 7(a) lender told me that while its loan numbers had increased 25 percent over the previous year, absolutely no commensurate change in profitability resulted. In addition, several institutions have advised me that they do not expect to renew their NAGGL membership because their future operational plans call for suspension or termination of their participation as 7(a) and 504 program first mortgage lenders. But the real losers in these difficult times will be the small businesses that desperately need the help of the SBA and its lending partners.

NAGGL is well aware that some regard "profit" as a dirty word when it comes to assessing a lender's internal decision to participate in the 7(a) program. The hard truth is that virtually all participating lenders are organized as for-profit enterprises, which means that they have a duty to their shareholders to realize a profit from each line of business. And while most 7(a) participants subscribe to the theory of "doing good while doing well", they cannot continue participation in the program unless they maintain an appropriate level of profitability from their 7(a) operations. Given this, NAGGL believes that unless the decrease in profitability from 7(a) lending is halted, lenders will be unable to sustain or expand their SBA lending activity and the program will fail to meet the needs of small business in this tightening credit environment.

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Over the past decade and more, as a result of ever increasing delegations of responsibility, and of the agency's decision to make the program self-funding, lenders have had significantly increasing operational costs associated with their 7(a) program participation. Now, SBA has once again dramatically increased the costs for lenders, particularly higher volume lenders, to participate in the program by deciding to pass along to them the agency's out-of-pocket expenses for lender oversight. Although there are a number of factors that affect lenders' decisions to reduce or halt their 7(a) program participation, based on conversations with our members, we believe that "the straw that broke the camel's back" is the recent imposition of lender oversight fees for onsite and offsite (e.g., Loan and Lender Monitoring System – L/LMS) reviews and examinations.

In the minds of our lenders, nearly all of whom are currently regulated by the FDIC, the OCC, and the Federal Reserve Board, the accuracy of the D&B information is questionable and the benefit associated with the fees has not been adequately justified by the agency. The head of a lender's SBA loan division simply cannot justify to senior management SBA's existing fees in light of the benefits received. NAGGL fully supports lender oversight, but notes that statistics indicate that performance of the overall 7(a) loan portfolio is consistent with conventional small business loans and that according to SBA statistics, the majority of the problems in the 7(a) portfolio come from a few non-depository institutions and from lenders, active and inactive, with portfolios of less than $1 million. It is principally among these lenders that the "repair" problem exists. Yet all lenders and borrowers bear the burden of these lenders portfolios never being adequately reviewed while their own portfolios are constantly reviewed.

Therefore, on behalf of our membership, NAGGL respectfully requests that the agency indefinitely suspend its imposition of lender oversight fees for banks already regulated by the Federal government, and that it establish a ceiling on the fees imposed on non-Federally regulated institutions. Such suspension should, at a minimum, remain in effect until a comprehensive review of the agency's lender oversight efforts is concluded. We do not believe this will in any way affect the quality of SBA's oversight efforts, and obviously will not affect the efforts of bank regulatory agencies.

On behalf of our member lending partners, I thank you in advance for your positive consideration of this request. We, like you, want the SBA program to be the fuel that drives the economy and moves our small business owners from success to significance. I would be pleased to meet with you to discuss our request.

Respectfully,

Anthony R. Wilkinson

Anthony R. Wilkinson
President and CEO

CC:
The Honorable John Kerry
Chairman
Committee on Small Business and Entrepreneurship
United States Senate
Washington, DC 20510

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The Honorable Olympia Snowe
Ranking Member
Committee on Small Business and Entrepreneurship
United States Senate
Washington, DC 20510

The Honorable Nydia Velázquez
Chairwoman
Committee on Small Business
U.S. House of Representatives
Washington, DC 20515

The Honorable Steve Chabot
Ranking Member
Committee on Small Business
U.S. House of Representatives
Washington, DC 20510

NATIONAL ASSOCIATION
OF GOVERNMENT GUARANTEED LENDERS

February 25, 2008

The Honorable Steven Preston
Administrator, U.S. Small Business Administration
409 3rd Street SW
Washington, DC 20416

Dear Administrator Preston:

NAGGL has continued to monitor the subprime crisis and its effect on the 7(a) loan program. Since last fall, NAGGL and its members have been concerned with the declining SBA volume. We initially saw tightening underwriting standards and the corresponding credit crunch affect borrowers in the SBA*Express* program. Now we have recognized a systemic decline in the general 7(a) loan volume. The SBA 7(a) loan program should be expanding in this period and providing a means to assist more of the nation's small businesses; unfortunately, this is not the case during these difficult economic times.

NAGGL surveyed its members on January 29, 2008 in order to identify the reasons the SBA 7(a) program is not maximizing its effectiveness in meeting its economic and public policy goals for small businesses. Our questions were directed to members-of-record; i.e., the person member-institutions designate as being responsible for 7(a) lending. Depending upon the institution, the member of record may be the President, CEO, Division Manager, or other designee. However, it is *always* the person with direct familiarity of the 7(a) program, with knowledge of their respective 7(a) customer base, and with ongoing interaction with the agency.

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This letter summarizes the results of this recent member survey. The survey was an online questionnaire sent to all 700 members-of-record who represent the lenders that provide over 80% of the annual SBA lending volume. We received approximately 250 responses—a valid and meaningful cross-section of program participants. The survey results are illuminating and I would like to briefly share them with you:

1. 81% of respondents stated that their institutions have tightened credit underwriting standards for conventional loans.
2. 67% of respondents stated that their institutions have tightened credit underwriting standards for SBA loans.
3. 61% of respondents stated that they are seeing a decline in borrower loan demand.

Each of these responses confirms that we *are* in a credit crunch and the need for the SBA 7(a) program to help small businesses is enhanced. The next group of responses shows that SBA 7(a) policies need to be modified to reach the small businesses in need:

1. The top reason for the decline in 7(a) volume is the "decreased profitability of SBA lending due to lender fees and costs". This reason was cited more often than decreased demand due to "borrowers concerned about possible recession".
2. 71% of respondents did not reach their profitability budget goals in 2007.
3. 74% of respondents stated that the volume decline is *not* the result of lenders shifting to conventional products. This contradicts the explanation given by the SBA for declining 7(a) volume.

Without reasonable profits, lenders are unable to reinvest in their program to reach additional small businesses. Examples of the increasing costs and fees associated with providing SBA financing and preserving the conditional guarantee include SBA mandated onsite and offsite review fees and the ongoing SBA lender fee. At the very time the Federal Reserve is attempting to forestall a recession by reducing interest rates and by injecting liquidity into the banking system to persuade lenders to make credit available, SBA's small business lending policies are having the opposite result.

Of particular note—and an issue raised in my December 17, 2007 letter to you—is the agency's lender oversight program. Seventy-one percent of our members believe the agency's onsite reviews duplicate the oversight efforts of federal bank regulators. Nearly 73 percent of our members were unaware that the offsite lender oversight bill they will receive in April will be approximately four times as large as the bill they received last year. With the exception of a small handful of respondents, our members find no value in SBA's current offsite lender review program despite being responsible for its entire cost.

Lender after lender reported that the prospective increase in lender oversight fees will have a further negative impact on 7(a) lending. Comments by lenders such as "We may chose to close down the SBA department"; "Potential decrease in activity"; "We will do less of it" were common among the lenders who responded to the survey. When NAGGL gave the respondents an opportunity to comment on what program changes need to be made, the top write-in response was "fees are too high". This was cited three times as often as the second highest response.

Concerns regarding the adequacy of the offsite review process expressed by NAGGL's members were confirmed in a February 18, 2008 *Business Week* article, "Credit Scores: Not-So Magic Numbers," that raises serious concerns and accuracy issues when utilizing a predictive scoring

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model for large groups of loans. SBA's offsite program and its Dun & Bradstreet model appear to utilize the exact type of predictive model discussed in the article.

Mr. Administrator, the message from the lending community is clear—the current policies of the SBA, including its position on increasing lender fees, is detrimental to providing much needed capital to our small businesses and fulfilling the agency's public policy goals. In order to restore the importance of the SBA and regain the confidence of its lending partners, the SBA must address these issues and arrive at a mutually beneficial solution that is in the best interest of small businesses and the nation.

I hope you find this information useful and look forward to your timely response.

Respectfully,

Anthony R. Wilkinson

Anthony R. Wilkinson
President & CEO

NATIONAL ASSOCIATION
OF GOVERNMENT GUARANTEED LENDERS

February 25, 2008

Mr. Bryan Hooper
Director for Office of Credit Risk Management
U.S. Small Business Administration
409 3rd Street, SW
Washington, DC 20419

RIN No. 3245-AE14

Dear Mr. Hooper:

The National Association of Government Guaranteed Lenders, Inc. (NAGGL) appreciates the opportunity to comment on the U.S. Small Business Administration (SBA) proposed changes to 13 C.F.R 120 related to the Agency's Lender Oversight Program. We especially appreciate SBA's willingness to extend the comment period for an additional 60 days in order to allow sufficient time for input on this critically important proposed rule.

NAGGL has long supported the agency's attempts to create a more effective lender oversight program. We continue to support this important objective. We understand the proposed rule is intended to provide coordinated and effective oversight of financial institutions that originate and manage SBA-guaranteed loans, and we believe that many of the provisions of the proposed rule are necessary. However, NAGGL firmly believes that the rule is fundamentally flawed and that its implementation should be postponed until the agency has the opportunity to further examine the underlying premises on which the proposed rule is based.

As the SBA knows from our ongoing dialogue, NAGGL has serious concerns about the effectiveness and appropriateness of the Risk Management System, specifically the Loan and Lender Monitoring System (L/LMS), to accomplish its stated purpose. The SBA just published its final notice on the Risk Management System on May 16, 2007, and to the best of our knowledge, has not yet undertaken any formal third-party review of the system that would determine its true predictive capabilities. This issue is of particular concern since, as acknowledged by SBA in the preamble to the final notice on the Risk Rating System, that system "has not been available throughout an entire economic cycle." In addition, as it relates to the credit scoring aspect of the Risk Rating System, we note that credit scoring is still a relatively new tool for credit measurement. Both conventional wisdom and SBA's incumbent L/LMS contractor have concluded that credit scoring is of little value for loans in excess of $300,000, an amount which represents approximately half of the 7(a) loan portfolio and a substantial portion of the 504 loan portfolio. In addition, concerns about credit scoring made national headlines as recently as February 7, 2008, when, in a cover story entitled *Credit Scores: Not-So-Magic Numbers*, Business Week described serious flaws in credit scoring as a predictor of loan performance. For these reasons, the association remains unconvinced that the system is an appropriate tool for identifying SBA lending institutions with portfolios and operations that require additional SBA monitoring—*or* for the expansive role that this proposed rule would give the risk management system within SBA's decision-making process as it pertains to numerous aspects of lenders' loan program participation.

Since one of the stated purposes of the proposed rule is to codify in regulation the role of the Risk Management System and L/LMS system within SBA's oversight program, NAGGL believes that its ability to accomplish the intended purposes must be empirically tested by an independent third party before these regulations are finalized. We strongly recommend that this proposed rule not be made final until such independent third-party examination is completed, and the results analyzed and included in a proposed rule.

NAGGL is generally supportive of the agency's attempts to implement a robust oversight program for SBA Supervised Lenders, but we are concerned that some provisions of the proposed rule impose on these lenders greater restrictions and reporting requirements than those imposed on federally regulated lenders. This seems especially true in the case of those designated as Non-Federally Regulated Lenders (NFRL). NFRLs are already subject to regulatory oversight separate from SBA's oversight. The language in the preamble indicates that SBA's proposed treatment of SBA Supervised Lenders is intended to be akin to the treatment of federally regulated lenders by their regulators. Therefore, NAGGL requests that additional information be included in the preamble to any Final Rule explaining *how* SBA's treatment of the lenders that it supervises would be consistent with the oversight imposed on federally regulated lenders.

NAGGL is also concerned that many of the proposed rule's provisions are inappropriately broad and vague and do not allow SBA's lending partners to know with any degree of certainty what actions the SBA would take and when. Other provisions are not balanced regarding the rights and obligations of the lenders and of the SBA, especially the timeframes that would be imposed on lenders for various actions, as contrasted with the timeframes--or complete absence of timeframes--that SBA would impose on itself. NAGGL objects to the many instances throughout the rule in which the SBA has repeatedly given itself "sole discretion" to decide various issues. The association believes that where SBA finds it necessary to give itself such broad discretion, the rule should clearly state the factors that will be considered in the decision-making process, and to the greatest extent possible, the relative weight of these factors. With those general concerns in mind, NAGGL offers these additional comments on some of the pertinent provisions of the proposed rule as they apply to 7(a) lenders. For ease of review, our comments are grouped generally under the major headings cited in the preamble to the proposed rule.

SBA Supervised Lender Regulation. NAGGL agrees that SBA has a high degree of responsibility in its oversight of lenders that are not otherwise federally regulated, including the Small Business Lending Companies (SBLCs) and NFRLs. NAGGL supports the provisions of the proposed rule that would adopt standards similar to those established by the regulators for federally regulated institutions with regard to issues such as capital, oversight and enforcement. However, we believe that the proposed rule contains provisions that impose greater restriction on SBA Supervised Lenders than those imposed on federally regulated institutions. We request that the SBA provide additional information to explain the basis for the requirements, particularly the reporting requirements that it would impose on the lenders that it supervises.

Capital Regulation. NAGGL also generally supports the proposed capital requirements, particularly as they would relate to federally regulated lenders and NFRLs. However, we have some concerns about the provisions in proposed Sections 120.471-474. In particular, we note that the provisions of Section 120.472 would give the Associate Administrator for Capital Access (AA/CA) "sole discretion" to decide that an individual SBLC would be required to maintain a higher level of capital based on his/her determination that the entity's capital level would be potentially inadequate to protect SBA from loss due to financial failure of the SBLC. And, we find the list of examples of factors that may cause this conclusion to be inappropriately broad and vague, particularly 120.472(e) and (f). We recommend that this list of examples be more fully explained in order to give SBLCs appropriate notice of the types of factors that SBA would consider. NAGGL also recommends that the decision to require additional capital be removed from the AA/CA and assigned to the Lender Oversight Committee.

Incorporation of a Risk Rating System. Until the existing Risk Rating System is further studied and validated empirically, NAGGL strongly opposes the proposed incorporation of this system into the agency's oversight program.

Various sections of the proposed regulation make the system a key component of SBA's decision-making process for at least eight issues of great importance to lenders. These include the agency's determinations regarding:

(1) A lender's continuing ability to handle all aspects of SBA lending [120.310(a)(2)];
(2) Whether a lender should be approved to securitize its loans [120.424(b)];
(3) Whether a lender meets the requirements for sales of loans or participating interests [120.433(b);
(4) Whether a lender meets requirements for loan pledges [120.434];
(5) Whether a lender should be initially approved for, or renewed, for PLP status [120.451(b)(3) and 120.451(e)];
(6) Whether a lender qualifies to be a pool assembler [120.630];
(7) How frequently a lender should be subjected to an onsite review [120.1051]; and,
(8) Whether enforcement actions should be imposed [120.1400(c)(4) and 120.1400(c)(9)].

Given the importance of these decisions to a lender's continuing ability to participate in the 7(a) program, NAGGL believes that the decision-making process should not be so heavily dependent upon the unproven SBA Risk Rating System.

Single Act Audit Provision. Inasmuch as this topic relates only to CDCs, NAGGL offers no comments on this topic.

Enforcement Policies and Procedures. NAGGL generally opposes the broad discretion that SBA would give itself throughout the regulatory provisions related to enforcement, and offer the following comments on specific provisions within the section.

Section 120.1400(b) is unclear and needs to be rewritten to clarify its meaning. Section 120.1400(c)(4) lists one of the grounds that may trigger an enforcement action against any SBA lender as "not performing underwriting, closing, disbursing, servicing, liquidation, litigation or other actions in a commercial reasonable or prudent manner . . .;" and states that evidence of this violation may be a lender having a repeated Risk Rating or an onsite review/examination assessment that is Less Than Acceptable. In addition, Section 120.1400(c)(9) would give SBA authority to impose an enforcement action for "Any other reason that SBA determines may increase SBA's financial risk (for example, repeated Less Than Acceptable Risk Ratings . . .)" NAGGL does not believe that a low lender's risk rating is necessarily indicative of a lender's lack of appropriate care in handling SBA loans. The use of the word "repeated" makes these provisions overly subjective, particularly since a lender has no way of knowing how many low risk ratings it can be assigned before it will be subject to enforcement action. NAGGL also notes that a single Less Than Acceptable rating on an onsite review/examination should not be deemed sufficient to trigger an enforcement action. Section 120.1400(c)(6) would give SBA the authority to implement an enforcement action against a lender based on SBA's determination that the lender is "engaging in a pattern of uncooperative behavior" or taking other stated actions detrimental to an SBA program ,or not consistent with standards of good conduct. This section is extraordinarily broad and SBA should provide examples of the types of behavior that it would consider appropriate to trigger imposition of an enforcement action.

Section 120.1500(a)(3), which discusses non-immediate suspensions, specifically states that a suspension or revocation would not invalidate a guarantee previously provided by the SBA. NAGGL believes this statement of intent should apply to all enforcement actions, so should be included in the introductory paragraph of Section 120.1500.

Section 120.1500(b) would provide an additional enforcement action that SBA may take against 7(a) lenders: the suspension or revocation of a lender's authority to sell or purchase loans or certificates in the Secondary Market. The stated rationale is SBA's attempt to limit a lender's risk exposure to SBA and the Secondary Market. As the SBA is aware, many lenders are reliant on access to the Secondary Market in order to continue their 7(a) lending activities, with approximately half of all 7(a) loans being sold. For these lenders, this enforcement action is tantamount to a program suspension or termination--remedies which are specifically included as separate enforcement actions. In addition, imposition of this enforcement action would create an uneven playing field: lenders that rely on the Secondary Market to carry out their 7(a) program would suffer disproportionately from the imposition of this enforcement action. Regarding the SBA's rationale for including this enforcement action, we would note that purchasers in the Secondary Market conduct extensive due diligence. It is not an appropriate role for the SBA to provide additional protection for the participants in this marketplace. Finally, as to the need for SBA to protect itself from a lender's risk exposure: even though the SBA provides a full faith and credit guarantee on the SBA-guaranteed shares of loans sold in the secondary market, the agency has very little risk of loss. Even if the SBA determines the need to repair or deny liability on any loan, it is the lender that ultimately bears the risk of loss. For the reasons noted, NAGGL strongly recommends that this provision be removed as a proposed enforcement action.

Section 120.1600 would set forth the general procedures for the SBA's imposition of enforcement actions. In accordance with this section, a lender would have 30 days, or some other period as arbitrarily established by the SBA, to file a written objection to a proposed action, other than an immediate suspension. However, under Section 120.1600(a)(3)(i) there *is no similar time limit imposed on the SBA*. Rather, the SBA would be authorized to respond "whenever it deems appropriate." Similarly in Section 120.1600(a)(3)(ii) allows itself 90 days after receiving a lender's appeal of the agency's decision for immediate suspension to advise the lender whether SBA would continue with the immediate suspension. NAGGL objects to the response times provided in each of these subparagraphs. For actions other than immediate suspensions, it would be appropriate to mandate an agency response time of no more than 60 days. Specifying a prompt response time would enable a lender to plan with some degree of certainty regarding its ongoing 7(a) operations. In the case of an immediate suspension, NAGGL believes that allowing the agency to have 90 days to make its decision—a period during which the lender would be suspended—is unreasonable and does not provide appropriate due process. NAGGL believes that decisions whether to continue a suspension should be made as soon as possible after the lender's response is received, but in no case later that 30 days from such receipt. If deemed absolutely necessary, the SBA could consider including a provision allowing for an extension of these deadlines for just cause.

Section 120.1600(a)(5) would mandate that a lender appeal the final agency decision only in the appropriate federal district court. The preamble to the proposed rule indicates that this is a change that would eliminate the role of SBA's Office of Hearings and Appeals (OHA) from the appeals process, but does not explain *why* this change is being made. NAGGL believes that the SBA should suspend imposition of this proposed change until it has provided sufficient information to lenders and other interested parties to enable them to determine that the proposed change is appropriate. Of special concern is the relative cost to and time required for a lender to appeal any decisions to OHA versus an appeal to a Federal District Court.

We also note that Section 120.1400(a) states that by making an SBA guaranteed loan, a lender would automatically be presumed to have agreed to the terms, conditions and remedies in Loan Program Requirements as issued by SBA from time-to-time and "as if fully set forth in the SBA Form 750, Loan Guaranty Agreement ... ." The 750 Form available through the agency website, and believed to be the one in current use, is dated October 1983, and contains numerous significant requirements that are no longer applicable. These include requirements that a lender submit quarterly reports on the status of its loans, despite the fact that monthly reports have been required for more than a decade; that a lender pay a 1% guarantee fee on each loan, despite statutory changes to the fee structure made many years ago; and that SBA honor guarantee purchase requests within 30 days of receipt, a time frame virtually never met.

As part of its recommendations regarding the SOP 50-10 modernization, NAGGL requested that the 750 form be revised. Last November, the agency advised that it would not undertake the revision at that time. We believe that it is inappropriate for the SBA to continue to cite SBA Form 750 as the contract between SBA and its lender partners when it is so seriously out-of-date. Therefore, although not specifically related to this rule promulgation process, we again strongly recommend that SBA Form 750 be revised, or that all references to it as a controlling document be deleted from SBA's Program Requirements.

Comments on Additional Provision. Section 120.451 discusses how lenders obtain PLP status, and states that final decisions regarding PLP approvals and renewals will be made by an

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"appropriate Office of Capital Access official in accordance with Delegations of Authority . . . " Since the agency publishes its Delegations of Authority for information purposes only, and does not invite or consider public comment, NAGGL asserts its opinion that final decisions regarding program participation, including PLP and other special program status, should be made by the Director, Office of Financial Assistance, with input from the Director, Office of Credit Risk Management.

Finally, we are disappointed to note the nearly complete absence in the proposed rule of any reference to the public policy purpose underlying SBA's loan programs. Only in the preamble did we find any mention of the possibility that a lender's "contribution towards [the] SBA mission" would be considered as an additional factor when SBA evaluates a lender with repeated Less Than Acceptable Risk ratings to determine whether enforcement actions are necessary, or when determining whether to renew a Lender's Preferred Lender Program (PLP) status. And, nowhere in the proposed rule is there any indication that the agency recognizes that, implicit in the statutory mandate of providing credit where it is not otherwise available, is the idea that the risk in SBA's program should generally be somewhat greater than the risk in conventional lending.

From the language in the proposed rule, it is clear that SBA is attempting to model its oversight program after those of the federal financial institution regulators. And, we believe that, in many ways this is a sound strategy. We note, however, that SBA's risk of loss from its loan programs, particularly the 7(a) program, is very different from the risk of loss that would be associated with the Federal Depository Insurance program. Both the 7(a) and the 504 programs operate, and have done so for a number of years, at zero subsidy. The lenders and borrowers that participate in these programs are already bearing the risk of program loss through the fees that they pay to the SBA. In fact, since credit reform was instituted, the program fees collected in most years have contributed more to the Treasury than necessary to cover projected losses. And, as to the risk of loss on any individual 7(a) loan, it must be pointed out that if a lender does not fully comply with SBA program requirements or prudent lending practices, the SBA will not honor its guarantee on the loan–so again, the lender bears the full risk of loss.

Despite the SBA's stated goal of managing program risk, there is a risk that is not addressed in the proposed rule: the risk that, in its zeal to minimize the agency's risk, the SBA creates the risk that lenders will no longer be willing or able to make available the necessary capital to start and grow the small businesses that are so essential to the health of the American economy. While NAGGL continues to strongly support the overall concept of appropriate program oversight, we urge the SBA to give consideration to incorporating the mission of the program into its consideration of lender performance.

Thank you again for the opportunity to comment on this important proposed rule.

Respectfully,

Anthony R. Wilkinson

Anthony R. Wilkinson
President and CEO

NATIONAL ASSOCIATION
OF GOVERNMENT GUARANTEED LENDERS

(Supplemental Comments for RIN No. 3245-AE14)

February 29, 2008

Mr. Bryan Hooper
Director for Office of Credit Risk Management
U.S. Small Business Administration
409 3rd Street, SW
Washington, DC 20419

RE: RIN No. 3245-AE14

Dear Mr. Hooper:

By this letter, the National Association of Government Guaranteed Lenders (NAGGL) is supplementing its February 25, 2008 comment letter. Feedback from our members during the comment period makes it appropriate for us to offer additional comments, particularly related to the proposed collection of information. And, since these comments are related to that topic, in accordance with instructions provided at 72 FR 61767, we are also providing a copy of this letter to David Rosker, Office of Management and Budget.

SBA asked for specific comments on four topics: (1) whether the proposed collection of information is necessary, (2) the accuracy of SBA's estimate of the burden of the proposed collections, (3) ways to enhance the quality, utility and clarity of the information to be collected, and (4) ways to minimize the burden of the collection of information on respondents.

(1) Whether the proposed collection of information is necessary

Please refer to our comment letter dated February 25, 2008. In that letter we stated that we believed that it would be appropriate for SBA to provide more detailed information explaining how SBA's treatment of the lenders that it supervises would be consistent with the oversight imposed on federally regulated lenders. Such information is essential to allow us to appropriately address the issue of whether the data that SBA intends to collect is necessary for the proper performance of SBA's functions.

(2) Accuracy of SBA's estimate of the burden of the proposed collections

While the information provided by the SBA is insufficient for us to fully analyze this question, we believe that the estimated cost burden on lenders to comply with the proposed data collections may be understated. For example, when estimating the Baseline Costs for Small Business Lending Companies (SBLCs), SBA assumed an annual outside audit fee of $8,000 plus an additional $2,000 for in-house costs for the respondents. Given the nature of the statements to be required from the SBLCs, we believe the estimated cost may be understated, and that the actual cost to lenders may be significantly higher. We note too, that the preamble to the proposed rule indicates that there would be no increase in the baseline costs for 7(a) lenders (excluding SBA Supervised Lenders) and for Non Federally Regulated Lenders (NFRLs). We concur with that conclusion – except that we would note that no estimate is provided on the costs that would accrue to lenders against which SBA would propose to take enforcement actions. We believe that prior to the implementation of this proposed rule, the SBA should provide estimates of the costs that could be incurred by lenders in connection with their responses to the agency regarding proposed enforcement actions, as well as the information requested in our previous letter related to the costs of appealing proposed enforcement actions to a Federal District Court, as opposed to appealing such proposals to the U.S. Small Business Administration Office of Hearings and Appeals (OHA).

(3) Ways to enhance the quality, utility and clarity of the information to be collected

Since the inception of the "new" SBA lender oversight program, NAGGL has pointed out that much of the data that SBA believes that it needs to oversee Federally Regulated and *Other Regulated* 7(a) program participants may already be available through the Federal Regulatory entities. And, we have encouraged the SBA to take whatever steps are necessary for it to gain access to this information. We believe that the agency has made some attempts to get information already held by the Federal regulators, but we do not believe that these efforts have been whole-hearted. In this regard, NAGGL recommends that the SBA provide detailed information on the steps that it has taken to establish information-sharing opportunities between the SBA and the Federal Regulators, *and* an analysis of whether the cost burden on the lender, particularly the costs for onsite review could be reduced if such relationships were forged. We also recommend that the SBA consider whether it could seek legislative authority to gain access to Federal Regulator data if the regulatory institutions are unwilling or unable to share necessary information.

(4) Ways to minimize the burden of the collection of information on respondents

NAGGL has always strongly supported the development and implementation of SBA's online application process – *e-Tran* – which was recently expanded to support some loan servicing actions. We believe that the SBA should vigorously pursue an expansion of this system, or the creation of a similar parallel system, that would provide for the automated collection of the information proposed to be required in connection with the lender oversight function.

Finally, as several NAGGL members have pointed out, in its original letter, NAGGL failed to comment on the high costs to lenders of the agency's proposed lender oversight program, and the perception of the actual value to be derived by the lenders and by the SBA from the program. In this regard, we note that on behalf of its 700 member institutions, NAGGL provided extensive comments on the proposed rule on Office of Lender Oversight fees. Those comments had little or no effect on changing the proposed rule. So today, 7(a) lenders, faced with operating in uncertain economic times, are being required to pay fees representing their share cost of the agency's Risk Rating System, particularly the Loan and Lender Monitoring System (L/LMS); and, for those lenders designated by the SBA to receive onsite reviews/examinations, for the actual costs of those reviews/examinations.

SBA Administrator Preston recently testified that these fees are minimal and are having little effect on lenders' participation in SBA's programs. We must respectfully disagree with that conclusion. Close to 250 NAGGL member-institutions responded a recent survey on 7(a) program participation. The vast majority of those respondents indicated that SBA fees are becoming a serious impediment to continuing 7(a) program participation. And, what must be considered here is that lenders are faced with a whole host of increased costs for program participation, with the lender oversight fees being only one aspect of those costs. In addition to their out-of-pocket oversight fees, lenders continue to pay high guarantee and ongoing fees on the loans in their portfolios, and they are also required to bear the costs inherent in the implementation of recent program changes. These costs arise from a number of program changes: (1) SBA's new requirement that a lender liquidate chattels prior to requesting that SBA honor a loan guarantee, thus adversely impacting the lender's cash flow; (2) the new absolute limitation to 120 days on the amount of interest that the SBA will pay on a defaulted loan *regardless* of how long it takes a lender to prudently handle required liquidation actions; (3)

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significant delays in SBA's handling of loan purchase requests, etc. Taken together, the existing loan program fees, the new oversight fees, and the hidden fees that come with new program procedures, impose significant cost burdens on 7(a) lenders, and place the agency at risk for having even more lenders reduce or terminate their program participation. Given the current state of the economy, and the important role that small businesses play in assuring the overall health of the economy, that result would be disastrous.

Thank you again for the opportunity to comment on this important proposed rule.

Sincerely,

Anthony R. Wilkinson

Anthony R. Wilkinson
President and CEO